Poland: Transition and Integration in the World Economy

by

Stanislaw Wellisz, Columbia University

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1. The transition: A Brief Overview.

The East-Central European communist regimes that came into power at the close of World War II sought to eradicate the market mechanism and to insulate their countries from the capitalist West. Poland was no exception: most of its exports were directed to, and most of its imports were obtained from other COMECON members, in particular from the Soviet Union. Gradually, however, the leadership of PZPR, the Polish United Workers' (communist) party realized that the command system and isolation from the world spelled stagnation. Sporadic attempts at reform were made as early as 1956, but the system remained virtually unchanged for the next twenty five years.

In the 1970s growth slowed down, while social opposition to the regime gained in strength. The Party made an abortive effort to improve economic performance by importing foreign technology. This strategy having failed, the July 1981 Party Congress adopted a reform program calling for increasing reliance on the market mechanism and for the opening of the economy\(^1\). But the November 13, 1981 declaration of the "state of war" by Wojciech Jaruzelski, who combined the offices of Prime Minister, Defence Minister and First Secretary of PZPR, delayed implementation. After the return to "normalcy" various measures were taken to decentralize economic

\(^1\). See, The World Bank (1987)
decision-making. The scope of central allocation of raw materials was reduced. Enterprises were granted more freedom of decision concerning production, marketing (including foreign sales) and investment. The market was allowed a greater role in price determination. Yet progress was slow: the ruling Party was clearly aware of the risk that economic reform would lead to the loss of power.²

The Solidarity-led regime which was formed in the Fall of 1989³ inherited a partially liberalized and half-dismantled command system, and an economy hovering on the verge of a hyperinflation. It also inherited a staggering foreign debt - the result of the ill-conceived foreign loan-financed modernization policy of the 1970s.

The new regime faced two immediate tasks: to bring down the rate of inflation, and to restore internal and external market equilibrium. January 1, 1990 heralded the implementation of a bold, ____________

². See Fallenbuchl (1988) and Poznanski (1988)

³. In the parliamentary election of June 1989, a 65 per cent of the seats in the Sejm (the lower chamber) were reserved for the PZPR and for two satellite parties, the United Peasant Party (PZPL) and the Democratic Party (SD). Solidarity won all the seats it was allowed to contest, and 99 out of 100 Senat (upper chamber) seats. As a compromise between Solidarity and the PZPR General Jaruzelski, First Secretary of the PZPR, became President, while Tadeusz Mazowiecki, a ranking member of Solidarity became Prime Minister. Mazowiecki’s government included members of Solidarity as well as members of PZPR, and of the Peasant the Democratic parties. When the new government was formed, the satellite parties distanced themselves from the PZPR.
comprehensive stabilization-cum-liberalization program, known as the "Balcerowicz Plan"\textsuperscript{4}. The budget was balanced by making drastic cuts in subsidies. Virtually all direct controls limiting internal and international commercial transactions were swept away. The currency was made "internally convertible"\textsuperscript{5}. The door was open wide to foreign investment. Though a number of key issues, among them the problem of foreign debt, remained to be settled, Poland seemed to be well on the way to full integration in the world system.

The reforms ran into social and political obstacles. Interest groups, among whom the farmers were the most important, pressured the government to retreat from extreme liberalism. The centrist governments, formed after the first completely free parliamentary elections (October 1991), were weak and lacked clear economic vision, hence they were fearful of further change and ready to compromise\textsuperscript{6}. Victory in the next parliamentary election (September 1993) went to a Democratic Union (neo-communist) - Peasant Party alliance. The peasant-neo-communist government asserted its commitment to the continuation of reform, the tempo of change slowed down even more, and, in some important respects, there was retrogression.

\textsuperscript{4} So-called after the Finance Minister and Vice-Premier Leszek Balcerowicz. For a comprehensive discussion of the Balcerowicz Plan see Wellisz, Kierzkowski and Okolski (1993).

\textsuperscript{5} See Section 2

\textsuperscript{6} The 1991 election was contested by a large number of small parties, none of which won enough votes to form a stable government.
Poland's current position vis-a-vis the world economy was thus largely determined by the Balcerowicz reforms. The changes that occurred toward the end of the communist regime constitute, as it were, a prelude. What happened since is a postlude. A discussion of Poland's international position must, therefore, pay special attention to the 1990-1991 period.

The balance of this chapter is organized as follows. Section 2 is devoted to a discussion of the evolution of the foreign exchange regime. Section 3 discusses foreign trade, Section 4 the debt problem, and Section 5 the treatment of foreign investment. Section 6 makes an appraisal of the degree of integration that has been achieved and looks into the future.

2. The foreign exchange regime

During the 1980s the "classical" communist system of direct allocation of foreign currency was replaced by a multiple exchange system. Less than a third of the available foreign currency continued to be directly allocated to high priority imports at the official rate. Enterprises were permitted to retain a portion of their foreign exchange earnings which could be deposited in foreign-exchange denominated accounts at Polish banks or utilized for the purchase of approved imports. Starting May 1987,  

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7 A more detailed analysis of the evolution of the foreign exchange regime will be found in Wellisz (1995)
enterprises were also permitted to sell and purchase foreign exchange at currency auctions held by the Export Development Bank. The proportion of earnings that could be retained was industry-specific, and the auction mechanism was government-controlled, hence the exchange rate varied from product to product. There was, also a free rate: individuals were permitted to buy and sell foreign currency on a semi-legal free market.


The Solidarity-led government took immediate steps to simplify the system and narrow the gap between the three rates. During the Fall of 1989, the official price of the dollar was raised, in steps, by 390 per cent; in real terms the zloty was devalued by 75 per cent. In September 1989, the free market price of the dollar was six times higher than the official rate. By the last week of December, 1989, the official rate stood at 5,600 zl/$, the average auction rate at 6,000 zl/$ and the free rate at 8,000 to 9,000 zl/$.

The exchange rate regime appropriate for the transition period was subject to an exhaustive discussion. The need to restore confidence dictated the establishment of a realistic, sustainable parity. On the other hand, it was argued that, given the difficulty of determining the appropriate parity level, it would be preferable to adopt a flexible system. The government opted for a compromise course. Within the framework of the reforms instituted on January
1, 1990, foreign currency was made freely available at the official rate for all current account payments. The retention accounts and the auction system were abolished. The conversion of export proceeds into zlotys at the official rate was made obligatory. Enterprises were permitted to retain, but not to replenish, their foreign-denominated accounts, and they were not allowed to establish accounts abroad. Consumers remained free to buy and sell foreign exchange on the free market. They were permitted to hold foreign-exchange denominated accounts in Polish banks, and, up to a limit, they could take the foreign exchange out of the country for personal use. The government pledged to maintain the a fixed exchange rate of 9,500 zl/US $ for three months, after which the rate could be adjusted, if necessary.

The announcement that the initial exchange rate was to hold for a pre-determined period opened the door to potentially destabilizing speculation. In its fight against inflation, the National Bank of Poland (NBP) set its discount rate (which constitutes a floor to the interest rate structure) slightly above the anticipated rate of inflation. The monthly rates for January, February and March were set respectively at 36 per cent, 20 per cent and 10 per cent. Since the rate paid on zloty deposits closely tracked the discount rate, a depositor who switched from dollars to zlotys at the beginning of January and back to dollars

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8. The official rate and the free market rate were, however, never allowed to deviate by more than a few percentage points.
at the end of March could have earned a 70 per cent return on his dollar savings. Large-scale speculation could have precipitated a collapse of the exchange rate\(^9\). However, the government's declaration that the rate would remain fixed for three months seemingly lacked credibility: very little switching and re-switching took place, and the initial undervaluation of the zloty permitted the government to adhere to its pledge despite the liberalization-induced price rise.

Within a few months inflation appeared to be well under control\(^10\). If anything, the restrictive monetary and fiscal policies seemed to be working "too well". There was excessively rapid accumulation of foreign reserves. The fiscal budget was in surplus\(^11\). There were signals that the stringent policy measures were about to precipitate a serious recession: the volume of credit (in real terms) declined; output fell, and unemployment began to rise.

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\(^{9}\) Guestimates indicate that private dollar hoards totalled $6 to $9 billion, surpassing by a factor of 3 or more the official reserves.

\(^{10}\) The monthly rate of increase of the consumer price index declined from 79.6 per cent in January, 1990 to 4.6 per cent in May, and to 3.6 per cent in June. Price stability by end-year seemed to be an achievable goal.

\(^{11}\) The IMF-approved stabilization plan called for the fiscal deficit of the first half of the year to be compensated by a second half-year surplus.
To stimulate the economy the government relaxed its monetary policies and raised the fiscal expenditures\textsuperscript{12} The immediate results were positive. The economy picked up temporarily, while inflation continued to abate.

By September 1990, the rate of inflation accelerated, however, while the general economic situation continued to worsen. In 1991 there was a sharp decline in the profits of state-owned enterprises (SOEs) depriving the government of a major source of revenue\textsuperscript{13}. The budget was again in deficit feeding inflation\textsuperscript{14}. The zloty appreciated in real terms until May 17, 1991 when its price was lowered to 11,000 zl/$. At the same time the zloty was de-linked from the dollar, and linked to a foreign exchange basket in which the US$ was assigned a weight of 45 per cent, the DM 35 per cent, the Pound Sterling 10 per cent, and the French and Swiss Francs 5 per cent each.

\textsuperscript{12} Measures taken to slow down the accumulation of reserves also included a temporary reduction or suspension of customs duties. See section 3 below.

\textsuperscript{13}. The high paper profits, registered by SOEs in 1990 inflation reflected lags in the revaluation of inventories and of depreciation allowances. Paper profits were also made on the increase in the zloty value of foreign exchange accounts held by enterprises. In 1991 and in the subsequent years the SOEs as a whole recorded losses.

\textsuperscript{14}. On this issue, see Gomulka (1994)
The shift to a currency basket was not unjustified. As long as the dollar linkage was maintained, the fluctuations in the dollar-ECU exchange rate introduced an extraneous disturbing factor in the trade between Poland and Western Europe, Poland's main trading partner. The relative weights in the basket seemed well chosen. Though trade with the U.S. is of little significance, dollar-priced imports, such as oil, amount to a substantial proportion of Poland's imports; hence the assignment of the major weight to the dollar. The second highest weight attached to the DM reflects the fact that Germany is Poland's single largest trading partner. The weights attached to the other currencies also are defensible. But the linkage to a basket does not have the transparency, and it does not carry the credibility of linkage to a single, strong currency. The abandonment of the dollar standard looked like a signal of retreat from the fixed exchange rate policy.
Table 1

Indexes of Consumer prices and of the real effective exchange rate,
1991-1994 (1900 = 100)

<table>
<thead>
<tr>
<th>Year</th>
<th>Quarter</th>
<th>C.P.I.</th>
<th>Real effective exchange rate*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>I</td>
<td>153.6</td>
<td>145.5</td>
</tr>
<tr>
<td></td>
<td>II</td>
<td>171.5</td>
<td>160.6</td>
</tr>
<tr>
<td></td>
<td>III</td>
<td>181.9</td>
<td>154.9</td>
</tr>
<tr>
<td></td>
<td>IV</td>
<td>199.7</td>
<td>154.7</td>
</tr>
<tr>
<td>1992</td>
<td>I</td>
<td>225.6</td>
<td>154.6</td>
</tr>
<tr>
<td></td>
<td>II</td>
<td>246.1</td>
<td>147.9</td>
</tr>
<tr>
<td></td>
<td>III</td>
<td>264.6</td>
<td>148.8</td>
</tr>
<tr>
<td></td>
<td>IV</td>
<td>290.9</td>
<td>158.0</td>
</tr>
<tr>
<td>1993</td>
<td>I</td>
<td>319.0</td>
<td>165.7</td>
</tr>
<tr>
<td></td>
<td>II</td>
<td>339.8</td>
<td>165.8</td>
</tr>
<tr>
<td></td>
<td>III</td>
<td>357.2</td>
<td>160.6</td>
</tr>
<tr>
<td></td>
<td>IV</td>
<td>390.0</td>
<td>159.4</td>
</tr>
<tr>
<td>1994</td>
<td>I</td>
<td>419.3</td>
<td>164.3</td>
</tr>
<tr>
<td></td>
<td>II</td>
<td>447.3</td>
<td>165.2</td>
</tr>
<tr>
<td></td>
<td>III</td>
<td>475.9</td>
<td>164.1</td>
</tr>
<tr>
<td></td>
<td>IV</td>
<td>516.4</td>
<td>168.3</td>
</tr>
</tbody>
</table>

* in US $/ zloty, adjusted for changes in relative price levels.

Source: IMF

The "crawling peg" regime October 1 1991 - May 15, 1995

In the face of a continuing price rise the government announced, on October 1, 1991, the replacement of the fixed parity by a "crawling peg". Henceforth the nominal exchange rate of the zloty was to decline at a preannounced rate. Under such a policy, called by Dornbusch "the PPP - oriented exchange rule", the nominal

15. In 1991 the consumer price index rose by 59.1 per cent and the GDP deflator by 55.3 per cent.
exchange rate is adjusted to take into account the differential between the rate of inflation in the home country, and the rate of inflation of the major trading partners. The initial rate of "crawl" was set at 1.8 per cent per month (about 24 per cent per year). The rate of inflation outstripped, however, the rate of "crawl" and the zloty was devalued by an additional 12 per cent on February 26, 1992. Another devaluation (this time by 8 per cent) came on August 27, 1993, but, as the rate of inflation appeared to be slowing down, the rate of the "crawl" was cut to 1.6 per cent per month.

In 1993-1994 the inflationary pressure exercised by budgetary deficits subsided. The fiscal deficit declined, and the shortfall in government revenue was covered to an increasing extent through sale of government obligations on the financial market. As a consequence, the NBP claims on the general government, expressed in constant 1990 zlotys, began to decline (Table 2)
Table 2
Fiscal deficits and domestic reserves of the National Bank of Poland, 1991 = 1994

<table>
<thead>
<tr>
<th>Year</th>
<th>Fiscal budget surplus or deficit (per cent of the GDP)</th>
<th>NBP claims on general government (trillions of 1990 zlotys)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>+0.4</td>
<td>0.60</td>
</tr>
<tr>
<td>1991</td>
<td>-7.0</td>
<td>2.47</td>
</tr>
<tr>
<td>1992</td>
<td>-6.0</td>
<td>4.74</td>
</tr>
<tr>
<td>1993</td>
<td>-2.7</td>
<td>4.47</td>
</tr>
<tr>
<td>1994</td>
<td>-3.2</td>
<td>4.17</td>
</tr>
</tbody>
</table>

Sources:
(A) Ministry of Finance and World Bank estimates, as reported in World Bank (1994). The fiscal deficit estimate for 1994 was reported in Rzeczpospolita no. 259 (3908) of 9.7,1994.
(B) IMF. The constant 1990 zloty values calculated by deflating the current zloty values by the consumer price index (1990 = 100)

Starting in mid-1993, however, the NBP had to cope with the inflationary effects of a rapid accumulation of foreign reserves. These rose from $3.3 billion at the end of the second quarter of 1993, to $5.7 billion at the end of the fourth quarter of 1994. The sources of this growth are yet to be determined; it is clear, however, that the accumulation is related to the undervaluation of the zloty. To remedy the situation, the NAP reduced the rate of "crawl" to 1.4 per cent per month in mid-1994, and to 1.2 per cent per month in January 1995. At the same time, seeking to contain credit expansion, the NAP set the 1993 discount rate at 35 per cent per year. In 1994 inflation subsided, and the discount rate was

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16. According to the official trade and capital transaction statistics, Poland's balance of payments was negative in 1993 and in 1994. The accumulation of reserves may have arisen as a consequence of a surplus on unrecorded border trade, or of an unrecorded influx of speculative capital.
lowered to 33 per cent, but a year-end resurgence of inflation induced the NAP to rescind the reduction in February 1995 (since inflation seemed to be calming down, the cut was reinstated two months later).

The simultaneous enforcement of a slow crawl and a high nominal interest policy created the danger of destabilizing speculation. Once again it became attractive to switch from dollars to zloty accounts and back to dollars. Aware of this danger the NAP announced, on May 15 1995, a major policy shift. Henceforth the zloty would be permitted to fluctuate within the upper and lower crawling limits set by the NAP. The system is a variant of the familiar "snake in the tunnel". The floor and ceiling values provide an indication of the points at which the central banking authorities are ready to interfere. The behavior of the zloty would, in turn, provide a signal for the setting of the rate of "crawl". The new system is yet to pass the test of time, but the first indications are that the rate of foreign exchange inflow has diminished, and the inflation is subsiding. Thus, after a "crawling peg" detour, Poland may be moving to monetary stability that was sought by the 1990 reformers.
3. Foreign trade

Trade Under the Communist Regime

As in all the Soviet Bloc countries, Poland's trade under the communist regime was a state monopoly. Exports and imports were strictly subordinated to the plan and the direction and composition of trade were determined as much by political as by economic considerations. The trade was carried out under three different regimes. The highest priority was given to trade with the Council of Mutual Economic Assistance (CMEA, for short) partners conducted in so-called "transferable rubles". Most of the trade with the "West" was conducted in terms of convertible currencies. There were special barter agreements, mainly with developing countries.

Stalinism in Poland was a period of virtual economic isolation. In the 1960s, however, imports expanded faster than "national income produced"; exports grew, too, albeit at a slower rate. Between 1970 and 1978 imports were further boosted by a modernization drive which called for the acquisition of Western technology and of Western capital goods, undertaken under the leadership of Edward Gierek, then First Secretary of the PZPR. In

17. Though "national income produced" in the soviet-type economies differs from GDP, the intertemporal movements of the two series are closely correlated.

18. The modernization drive was masterminded by Edward Gierek, the then First Secretary of PZPR.
1978, burdened with foreign debt, and unable to obtain further loans, the government was forced to reduce imports and expand exports (Table 2).

The attempt at austerity added fuel to political discontent, leading to the rise of "Solidarity" (1980-1981). The imposition of martial law on November 12/13, 1981 permitted the government to renew its retrenchment efforts resulting in a sharp fall in income and an even sharper fall in imports.

Table 3
Indexes of "national income produced", imports and exports in constant 1970 prices (1960 = 100)

<table>
<thead>
<tr>
<th>Year</th>
<th>National income produced</th>
<th>imports</th>
<th>exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>56</td>
<td>41</td>
<td>64</td>
</tr>
<tr>
<td>1970</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>1978</td>
<td>184</td>
<td>229</td>
<td>198</td>
</tr>
<tr>
<td>1980</td>
<td>169</td>
<td>222</td>
<td>203</td>
</tr>
<tr>
<td>1981</td>
<td>149</td>
<td>185</td>
<td>164</td>
</tr>
<tr>
<td>1982</td>
<td>141</td>
<td>159</td>
<td>179</td>
</tr>
<tr>
<td>1989</td>
<td>182</td>
<td>239</td>
<td>262</td>
</tr>
</tbody>
</table>

Source: GUS (1990)

After reaching a nadir in 1982, the Polish economy recovered, though in 1988, the penultimate year of communist rule, the "national income produced" was still slightly below the 1978 peak. In 1988 imports were, however 4 per cent higher, and exports 32 per cent higher than ten years earlier.
The modernization drive of the 1970s marked the beginning of reorientation of trade away from CMEA. Western machinery purchased with Western credits required Western inputs which had to be paid for with hard currency earned by exporting. When, in the 1980s the regime attempted to inject market elements into the decision-making process, Western orientation became even more apparent. In 1981-1982 the State-Owned Enterprises (SOEs) were granted a degree of marketing autonomy. On October 30, 1988, the Council of Ministers approved the introduction of a non-discriminatory structure of customs duties, patterned, broadly speaking, after the tariff schedules of semi-industrialized countries. Trade monopolies were abolished by an ordinance of December 23, 1988 which became law in January 1989. Though in practice political considerations continued to play a key role, in practice the proportion of Polish exports to the CMEA countries declined from 64 per cent in 1970 to 54 per cent in 1982 and to 41 per cent in 1988, the last full year of communist rule.

The 1990 trade liberalization

January 1, 1990 saw the elimination of virtually all quantitative trade barriers. Polish enterprises were free to import and to export on their own account without obtaining permits. There

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19 Raw materials were exempt from duties, or subject to a low rate; finished products were more heavily protected. The unweighted average of rates was less than 12 per cent.

20 GUS (1990)
were only three exceptions to this rule: first, the reexport of raw materials imported from other CMEA countries (mainly from Russia) at lower-than-world prices was prohibited; second, coal exports were subject to quota restrictions (the domestic price of certain grades of coal continued to be maintained below the world price levels)\(^1\) and thirdly, Poland had to abide by import quotas set by Western Europe and by the United States on Polish textiles, steel and several other products.

The goal was to achieve trade balance for the year 1990 as a whole. Liberalization was expected to result in a rapid rise in imports and a more gradual expansion of exports. The current account would be in deficit during the first half of the year, but this deficit would be compensated by a surplus accumulated in the course of the next six months.

Much as expected consumers took advantage of liberalization to build up a stock of hitherto unavailable durables. But as the household stocks of durables rose, purchases declined. The undervaluation of the zloty, kept purchases of imported consumer durables in check. With the passing of socialism, there was also increasing anxiety about job security, and this, too, reduced demand for imported consumer durables. As the economy went into recession, imports of producer goods also declined. The domestic

\(^{21}\) The re-export provisions lapsed with the dissolution of the CMEA.
slump and the undervaluation of the zloty spurred exports. The trade balance turned positive as early as February 1990 leading, as mentioned earlier, to an undesired rise in foreign exchange reserves\(^2\).

To slow down the accumulation of reserves about 2/3 of all customs duties were reduced or suspended. The unweighted tariff average declined from 11.7 per cent to 5.8 per cent, and the trade-weighted average from 11.4 per cent to 5.8 per cent. In mid-1990 Poland came to enjoy a remarkable degree of free trade\(^2\).

The return to protectionism

The mid-1991 to mid-1993 period was marked by relative trade stagnation and by a return to protectionism. The two phenomena were doubtless connected, but in each exogenous factors played a key role. The stagnation of trade reflected, to a large extent, the West European economic slump. The return to protectionism - the victory of dirigiste political elements.\(^2\)

\(^2\). The accumulation of foreign exchange reserves was unwanted first, because of its inflationary effects, and secondly, because Poland had just entered into negotiations with its creditors. The rapid rise in reserves was harmful to Poland’s claim that the country was not able to meet its debt obligations.

\(^2\). See Nogaj (1992)

\(^2\). Poland is not the only post-communist country to retreat from trade liberalism. A general discussion of the issues involved will be found in Messerlin (1994). For a comparative study of Poland, Hungary, and the Czech and Slovak Republics, see Gacs (1994).
Though trade liberalization was at the heart of the 1990 reforms, the customs duty reductions and suspensions were looked upon as interim measures. There was need for a complete revision of the tariff system inherited from the communist regime. The number of tariff brackets was confusingly large. Similar products often fell into different tariff categories complicating clearance procedures and encouraging customs fraud and bribery. The duty on some intermediates was higher than that on the final products. The nomenclature was idiosyncratic and not readily translatable into the standard international system.

The revision process, which began in 1991, soon revealed a clash of conceptions and of interests. Technical advisors to the government favored the sweeping away of all protective measures, except for a revenue tariff. To minimize tariff-induced distortions, they proposed imposing a broad-based flat 10 per cent duty to which there would be few or no exceptions.

The free traders found themselves in opposition to a broad array of specific interests of which the farmers were the most powerful. Paradoxical as it may seem, Poland’s small private farmers fared well under communism. Under a policy instituted in the 1970s and in the 1980s agricultural inputs were available at stable, subsidized prices, and the home market was tightly protected. For the peasants the last years of communist rule brought exceptional prosperity. The average income of members of
peasant households surpassed that of workers' households by 16 per cent in 1987, by 23 per cent in 1988 and by 16 per cent in 1989.

The 1990 reforms brought hardship to the farmers. Agricultural subsidies declined from 5.6 per cent of GDP in 1989 to 1 per cent in 1990. The freeing of all consumer goods' prices, and the opening up of the home market to competition from better quality foreign dairy products, fruits and meats spelled a precipitous decline in the farmers' terms of trade. While the first years of transformation affected virtually all strata of society, farmers fared especially badly. The average farm income fell by 1991, to 84 per cent of the average income of the non-agricultural workers' households. The decline in fortunes led the farmers to organize a vigorous campaign for the restoration of the lost privileges, including demands for protection, and for duty-free importation of agricultural inputs, such as protein-rich fodder and machines which were not produced in Poland.

Powerful manufacturing interests also sought special favors. Poland has a comparative advantage in basic products; on the other hand, highly fabricated technologically-intensive products compete with foreign products with difficulty. The manufacturing sector favored a tariff structure in which the rates increase steeply with the degree of fabrication. Such a structure also found favor among government policy makers interested in fostering "high tech"

25 Dabrowski and Kwiecinski (1994)
industries. Paradoxically, even the Ministry of Cooperation with Foreign Countries pressed for higher tariffs. Poland had just entered into talks with the European Economic Community (EEC) and with the European Free Trade Area (EFTA) countries, and it wanted to participate in the General Agreement on Tariffs and Trade (GATT) Uruguay Round. What could it give away in exchange for foreign concessions if its tariffs were already low?

Fiscal stringency was yet another factor that tilted the scale in favor of protectionism. In 1991 it became evident that all possible sources of revenue had to be tapped to keep the fiscal deficit down to an acceptable level - an argument which was used by advocates of high duty rates on "luxury" goods the demand for which is presumed to be highly inelastic.

The protectionists won a clear victory. With the August 1, 1991 introduction of the new tariff schedule, the unweighted average of tariffs rose from 5.82 per cent to 16.83 per cent, and the weighted average from 5.49 per cent to 14.27 per cent.\textsuperscript{26} The new schedule comprised nine customs duty brackets, the lowest two (0 per cent and 5 per cent) applied to raw materials, and the highest (ranging from 35 per cent to 45 per cent and over) to highly sophisticated and "luxury" products. Most of the semi-fabrics were subject to a 15 per cent, and most of the finished

\textsuperscript{26}. These figures take into account temporary reductions and suspensions.
industrial products to a 30 per cent duty. A separate schedule applied to automobiles. Polish cars, inexpensive but inefficient, competed with used foreign-made cars rather than with the (much more expensive) new foreign cars. To protect the Polish car industry the tariff on used car imports was set at a higher level than on new cars, with the duty rate rising with the age of the car. Importation of cars more than 10 years old was prohibited.

**Table 4**

Import tariff rates prior to and after the August 1, 1991 tariff reform

<table>
<thead>
<tr>
<th></th>
<th>before 1.8. 1991</th>
<th>since 1.8.1991</th>
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</thead>
<tbody>
<tr>
<td><strong>Unweighted averages:</strong> (in per cent)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nominal rates</td>
<td>11.7</td>
<td>17.0</td>
</tr>
<tr>
<td>Actual rates*</td>
<td>5.8</td>
<td>16.8</td>
</tr>
<tr>
<td><strong>Weighted average:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nominal rates</td>
<td>3.4</td>
<td>16.2</td>
</tr>
<tr>
<td>Actual rates*</td>
<td>5.5</td>
<td>14.3</td>
</tr>
</tbody>
</table>

* Taking into account temporary tariff reductions and suspensions.


Farmers scored the greatest victory. Even before the general tariff revision they were granted special favors. Now they obtained higher protection than industry (Table 5). The next four years saw the banning of some food imports (e.g. of chicken thighs and legs), the introduction of seasonally varying tariffs and of "compensatory" tariffs equalizing the cost of selected agricultural imports with domestic reference prices.
Table 5

Actual industrial and agricultural average weighted tariff rates 1993 and 1994#

before 31.12.1993   since 1.1.1994

(in per cent)

Agricultural products 18.5   18.3
Industrial products 10.7   10.7
All products 11.7   11.6

# Exclusive of the 6% "border tax" levied on all imports.

Source: Press release of the Ministry for Foreign Cooperation reported by Nogaj (1994)

The new tariff schedule represented a compromise between the protection-seeking home producers and the purchasers of their products. Not surprisingly, a differentiated tariff could not satisfy everybody. A commission for tariff revision, formed in September 1992, considered 1300 petitions for change of which it accepted 300. Most of the changes involved greater tariff rate differentiation, but they had no significant effect on the average rate of protection (Table 5)

At the new, higher tariff rates imports generated more government revenue, but, in view of the persisting deficit, the government imposed an additional 6 per cent tax on the value of all imports, inclusive of customs duties. On July 5, 1993 this tax was converted into a 6 per cent customs duty. The duty was

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\[77\] Nogaj (1994) loc. cit.
calculated on the value of imports, inclusive of all other duties and taxes, such as the newly introduced Value Added Tax, and the excise taxes applicable to certain commodities, e.g. alcohol and tobacco. The duty remained in force in 1994; it was lowered to 5 per cent in 1955, and, fiscal conditions permitting, it is to be gradually phased out. The problem was that, under very optimistic assumptions, the 1995 fiscal deficit would amount to 10.7 per cent of the fiscal revenues, and to 3.3 per cent of the GNP. The budget projections assumed that the 5 per cent tax would contribute 3 per cent, and all customs duties and taxes 9.7 per cent of all fiscal revenues. To wean the government from dependence on import tax revenue would be a problem.

With the retreat from liberalism, trade policy came to be seen more and more as a tool of industrial policy. The first measures were modest in scope. In order to help the leather industry which was hurt by a rise in rawhide prices, the government raised in 1992 the turnover tax levied on rawhide exports from 20 per cent to 50 per cent, and, a year later it suspended import duties on rawhides. In mid-1993, the scope of ad-hoc measures was greatly expanded. Customs duties which were levied on a long list of products "needed for the reconstruction of the national economy" were reduced or suspended. The list included raw materials such as non-ferrous ores and concentrates, machinery (large tractors which

28. See Nogaj (1994a), 73-86

29. Dziennik Ustaw 1993, no. 53 item 245
were not produced in Poland, gas turbines and textile machinery) The newly-established auto assembly industry obtained a duty-free component import quota; the electronic industry obtained a similar privilege, as did a number of other industries, including some, such as the silk industry, most unlikely to survive foreign competition. A duty-free quota was set for products needed by the military and the police. A quota was also set for duty-free importation of equipment and of vehicles needed for oil and gas prospecting. A somewhat longer list of temporary reductions and suspensions applied in 1994. In the same year the government created a sugar producers' cartel. A tax was imposed on domestic sugar sales; the proceeds of this tax were to be used to subsidize exports needed to dispose of the sugar surplus created by the artificially high domestic sugar prices.

Quantitative export restrictions also reappeared. Poland exports steel; it also exports scrap iron and steel, utilized in steel-making. Exports of scrap in 1991 amounted to 1600 tons and in 1992 to 1300 tons. But in 1993, under pressure from the Polish steel industry a 600 ton limit was placed on scrap exports. In the course of the year the exporters were granted additional quotas, and total exports reached 1011.7 thousand tons. Despite the quota expansion, toward the end of 1993, the price of scrap in Germany was twice as high as in Poland. Not content with this result, the

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30. Dziennik Ustaw 1993, no. 128 item 592

25
steel interests pressured the government to reduce the 1994 scrap export quota to 400 tons\(^3\). 

The trend toward quantitative trade restrictions is spreading: with increasing frequency such restrictions are built into joint venture agreements, while many new contracts with foreign firms (e.g. in telecommunications) contain a domestic content provision.

**Change in the direction of trade**

The transition years (1990 - 1993) witnessed a striking reorientation of the direction of trade. As we saw earlier CMEA accounted for over 40 per cent of Poland's trade (exports plus imports) in 1988; in 1990 for only 25 per cent. The CMEA was dissolved in 1991. The dissolution was followed by transition difficulties in the former USSR, CMEA's dominant partner. By 1993 Eastern Europe accounted for less than 14 per cent of Poland's trade whereas 71 per cent was with the EEC and with EFTA. Gradually, however, normal links with Russia and the Ukraine are being reestablished: preliminary figures for 1994 show that Poland's trade with its Eastern partners is gaining in importance.

**Trade agreements**

The 1990 Balcerowicz reforms had one overriding goal: integration of Poland in the world economy. Poland opened up its markets, and it sought access to markets for Polish goods. To this

\[^3\] Woklodkiewicz-Donimirski (1994).
effect it undertook negotiations with GATT, with the European Economic Community, and with EFTA. Together with Hungary and Czechoslovakia it formed a Central European Free Trade Area (known as CEFTA or as the Visegrad Group).

Despite Poland's retreat from free trade these efforts did not flag in subsequent years. The goals changed, however. The negotiations took on a "strategic" character. Poland sought to obtain better access to foreign markets. It was willing, albeit reluctantly, to reduce its trade barriers in exchange for concessions.

The General Agreement on Tariffs and Trade

Poland joined the General Agreement on Tariffs and Trade in 1967, and obtained the status of a Most Favored Nation. In exchange for admission to the GATT, the candidate countries are usually asked to lower their tariffs. But tariff concessions are meaningless in the case of centrally planned economies. In lieu of such concessions Poland agreed in the Act of Accession to increase its imports from GATT member countries at a 7 per cent annual rate. This pledge was not honored from the mid-1970s on.

The implementation of the Balcerowicz reforms called for a redefinition of conditions of GATT membership. In November 1993 Poland joined the "Uruguay Round" of talks. Along with all other countries Poland submitted a schedule of base rate duties which
were to serve as a starting point for negotiations on multilateral reductions.

In the course of the negotiations Poland agreed to reduce by the year 2000 the average level of tariffs on industrial goods by 40 per cent and on agricultural goods respectively by 35 per cent, relative to a base level. It also pledged to "bind" 96 per cent of the eight-digit industrial import categories\(^32\) and all the agricultural import categories on the new, lower level.\(^33\) Poland also agreed to reduce the average mean support (AMS) provided to domestic agriculture by 20 per cent\(^34\), and to cut export subsidies by 36 per cent, and to refrain from imposing new quantitative import restraints. The "concessions" are of the same order of magnitude as those made by highly industrial countries, but in the case of Poland they overstate the degree of promised liberalization, especially as what concerns agriculture. Thus in 1990-1993 the AMS of Polish agriculture was approximately 40 per cent lower than in 1986-1988, the period used as a basis for the Uruguay Round reduction. As a consequence Poland may raise the degree of support, and yet adhere to its Uruguay Round schedule of

\(^32\) Automobile tariffs are the most important exception.

\(^33\) "Binding" implies an undertaking to refrain from future increase in the scheduled tariffs, except in specific circumstances enumerated in the protocol of the agreement.

\(^34\) The AMS is calculated as follows:

\[
\text{AMS} = Q(P-P^*) + S
\]

where \(Q\) = quantity produced, \(P\) = domestic price, \(P^*\) = import or export price and \(S\) = direct subsidy.
"cuts". The same holds for the export subsidies, most of which (sugar and powder milk being the only major exceptions) were swept away in 1990. Note, however, that a similar comment applies to Uruguay commitments of most of the developing, and of some of the highly developed countries\textsuperscript{35}.

The Treaty of Association with the European Economic Community

On October 16, 1991 Poland, Czecho-Slovakia and Hungary, signed a Treaty of Association with the European Economic Community\textsuperscript{36}. The Treaty calls for the harmonization of trade practices and for the establishment of free trade in industrial products. It also outlines the conditions which the three (now four) countries have to meet to qualify for full membership, without specifying, however, the time period within which such membership may be granted. Pending the completion of the ratification process, an Interim Agreement came into force on March 1, 1992 and the Agreement itself on February 1, 1994.

\textsuperscript{35} For the highly developed countries as a group the tariffs prior to the Uruguay round tariffs were "bound" at 6.0 per cent trade-weighed average. The actual average was equal to 5.0 per cent. After reduction the tariffs were bound at 5.0 per cent on the average. In the case of the United States and of the European Economic Community the actual protection rates are the same as the base period rates, but in the case of Australia the averages are 20.1 per cent, 10.0 per cent, and 12.2 per cent respectively. See Kirmani (1994)

\textsuperscript{36} The 1991 Treaty supplanted and enlarged an agreement for trade cooperation concluded in 1989 by Poland and the EEC.
Under the Treaty the EEC agreed to eliminate (between 1992 and 1996) all barriers limiting the importation of Polish industrial products. 37 All quotas on industrial products, other than those limiting the entry of coal, iron and steel, and textiles were eliminated by the end of 1994. Full liberalization of import of products which are covered by the European Coal and Steel Community is to be accomplished by the end of 1995, and the removal of quotas on textile and clothing by the beginning of 1998.

Poland, as the "weaker partner" was given ten years to eliminate all trade barriers against industrial imports from the Community. The liberalization of imports of raw materials and of capital goods in 1992 was a first step. All other restrictions, except those applying to automobiles, are to be removed in a phased manner during 1995 - 1999. A duty-free automobile import quota, established in 1992, is to be increased by 5 per cent per year between 1994 and 2002, by which year all restrictions (including the prohibition of importation of cars more than 10 years old) are to be removed.

Both sides may reimpose import restrictions under conditions specified by the GATT. Poland is also permitted to take protective measures if imports from the EEC endanger its infant industries, industries in the process of transformation, and those that

37 For the purpose of satisfying the EEC domestic content clause Poland, Hungary and Czecho-Slovakia (later the Czech and the Slovak Republics) are treated as one country.
encounter serious economic or social problems. Poland may also
grant special protection to EEC enterprises located in Poland. Thus
Poland is free to pursue an independent "industrial policy".
during the transformation period.

The Treaty does not call for the establishment of a free
market in agricultural goods. However, Poland gave the EEC
exporters a 10 percentage points customs tariff preference on 246
agricultural products, while the EEC undertook to enlarge its
import quotas. Both sides retain the right to conduct an
independent agricultural protection policy.

Poland-EFTA treaty

On November 15, 1993 Poland and the member countries of the
European Free Trade Agreement concluded a treaty the provisions of
which matched closely those of the Poland-EEC agreement. As in the
latter arrangements, restrictions against Polish products were to
be lifted more rapidly than those imposed by Poland. Since EFTA
countries did not pursue a common agricultural policy, partial
liberalization of trade in agricultural goods was covered by
bilateral treaties.

The "Visegrad Group"

Under the "Visegrad Agreement", signed on December 21, 1992,
Poland. Czecho-Slovakia and Hungary agreed to form the Central
European Free Trade Area (CEFTA), a common market in industrial
products. The implementation schedule called for a drastic reduction of barriers during the first five year period; the entire process was to be completed by the year 2001.

The agreement, however, has purely symbolic significance. In recent years Czecho-Slovakia accounted for less than 4 per cent of Poland's foreign trade, and Hungary for about 1 per cent. The three countries are to become gradually integrated in the broader European community hence CEFTA will, at most, have a marginal impact on the direction of trade.

4. Foreign debt.

In 1989, when the "Solidarity"-led government came into power Poland was unable to meet its foreign financial obligations. Though the country was in default, its program to restore democracy and free enterprise found favor in the West. Poland was offered aid and support of the IMF and of the World Bank. Yet a settlement of the debt issue was an essential prelude to full access to international financial markets. Negotiations with the creditors pre-date the "Solidarity" takeover; they were resumed by the "Solidarity" regime but the final settlement was not reached until 1994.
The genesis of the debt crisis

Poland's foreign debt problem dates to the 1970s. The communist regime, threatened by popular revolt, attempted simultaneously to increase the availability of consumer goods and to lay the foundations of future prosperity through the modernization of the economy. Foreign borrowing was to be the key to this strategy. Foreign credit was to be used to finance the purchase of Western technology and of Western equipment. Given the expected improvement in productivity, loan repayment would be no problem.

The ambitious program resulted in a rise of indebtedness from $200 million in 1970 to $12 billion in 1976. About 15 per cent of the loan proceeds were used for consumer goods imports and the availability of such goods was the one visible benefit of the program. 20 per cent of the credits were utilized to re-tool the economy (foreign credits financed nearly 25 per cent of gross investment). There was little improvement in productivity because of misdirection of investment and of the misuse of the new equipment. The utilization of the new equipment required the use of Western raw materials and semifabricates; 65 per cent of the loan money went for such imports.

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38. This section draws heavily on "Ciezar starych dlugow" (the burden of old debt) Nowa Europa November 19-21, 1994.
As the debt mounted, the government found it increasingly difficult to borrow new money and to refinance old loans. Interest rates rose and the repayment periods shrank. As early as 1977, Poland had trouble meeting its Western obligations. Attempts to rein in the economy precipitated a sharp recession and fuelled popular discontent but they did not solve the problem. In 1980, the year in which the "Solidarity" movement almost succeeded in toppling the regime, the convertible currency debt surpassed $24 billion, and debt service payments amounted to 96 per cent of total exports to the convertible currency countries. About 70 per cent of the debt was to become due for repayment between 1981 and 1983. The creditors recognized the fact that the repayment of $17 billion far surpassed the country’s capability. In April 1981, Poland reached an agreement with the "Paris Club" (the lender governments) delaying, till 1986-1989, 90 per cent of the payments on account of capital and of accumulated interest on long and medium-term loans. Negotiations were started toward a comprehensive debt restructuring agreement but these were interrupted when the government declared a "state of war" suspending civil liberties and jailing "Solidarity" leaders. As a consequence of this declaration, Poland was cut off from obtaining credits which were guaranteed by foreign governments. Negotiations which were also initiated with the "London Club" (the commercial lenders) prior to the "state of war", ultimately led to a rescheduling of repayment of 95% of the principal although Poland continued to be responsible for meeting

its interest payment obligations. Poland also obtained access to short-term, revolving credits.

Negotiations with both "clubs" resumed in 1984 and led to a series of piecemeal arrangements which gave temporary relief. Nevertheless, Poland was constantly in arrears on payments of its obligations and the country continued to be cut off from contracting new foreign-government guaranteed loans. The foreign debt kept mounting. During the 1980s Poland failed to meet two thirds of its interest obligations. In 1989 the value of the debt surpassed 500 per cent of the annual value of exports. The debt to Western creditors (including capitalized unpaid interest) amounted to $40.8 billion of which close to 70 per cent was due to the Paris Club. In addition, Poland owed 7 billion "convertible" rubles to its former COMECON partners.

**Agreement with the "Paris Club"

The advent of the Solidarity-led government brought much-needed debt relief. As early as October 1989, the "London Club" members agreed to delay the repayment of the principal and 85 per cent of interest payments due in the fourth quarter of the year. Following the adoption of the IMF-backed liberalization-cum-stabilization program, the "Paris Club" granted Poland a payments moratorium till the end of March, 1991. Negotiations aiming at a comprehensive solution were also resumed.
The April 1991 agreement, between Poland and the 17 "Paris Club" members involved a scaling down of the principal, recapitalization, and the rescheduling of payments. The program was to be implemented in two phases. The first phase (April 1, 1991-March 31, 1994) coincided in time with stabilization agreement reached between Poland and the International Monetary Fund. Poland’s payments of interest on the loans outstanding were reduced by 80 per cent. The overall net present value of the debt (due account being taken of the interest payment reduction) was cut by 30 per cent. Under the second phase, the net present value of the debt was to be reduced by another 20 per cent of the initial amount. The implementation of the second phase was to be contingent upon three conditions: first, the government was to adhere to an IMF-approved stabilization program; second, government would meet the (reduced) debt servicing obligations; finally, no agreements would be concluded giving other creditors more favorable treatment than was given to the Paris club members.40

The first two conditions were readily met. Negotiations with the commercial lenders (the London Club) took four years; an agreement fulfilling the third condition was signed on October 27, 1994.

40. Ministry of Finance press release
Reduction and conversion of the "London Club" obligations.

In the Fall of 1994 Poland reached an agreement with the "London Club" resulting in the scaling down of Poland's $14.39 billion commercial debt by 49.2 per cent.\(^{41}\) $870 million in overdue interest payments was cancelled outright; the Polish government agreed to a buyback of $3,250 million of its debt at a cost of $1,324.6 million\(^{42}\) and $10.27 billion of the old debt was converted into a new debt instrument with a nominal value of $7.98 million. The operation called for an immediate outlay of $1,324.6 million\(^{43}\), a major part of which was covered by the IMF, the World Bank, and the reserves of the National Bank of Poland\(^{44}\).

The cost of debt service under the agreements to rise gradually from $400 million in 1995 to $600 million by the turn of the century. The entire debt is to be repaid by the year 2024, and

\(^{41}\)The agreement with the "London Club" was signed on September 14, 1994 and it came into force on October 27 of the same year. Unless otherwise indicated, the discussion that follows is based on Ministry of Finance press releases.

\(^{42}\) $2.93 billion of the debt was to be bought back at 41 cents to the dollar and $320 million at 31 cents to the dollar.

\(^{43}\) Of this sum $1,324.6 million was needed for the debt buyback, and $623 million for the purchase of U.S. treasury obligations. These were deposited with the Federal Reserve Bank of New York to be used (at the end of 30 years) to repurchase $4.8 billion of the new obligations.

\(^{44}\) The loans advanced by the IMF and by the World Bank amounted, respectively, to $900 million and $400 million, while $440 million came out of the reserves of the National Bank of Poland. $137.7 million was obtained under the "new money agreement" and $70 was provided within the 1994 budget.
the average payment the entire 30 year period amounts to $561.7 million.

The reduction agreements notwithstanding Poland continues to bear a heavy burden of external debt. According to the Ministry of Finance Poland owed foreign creditors $47.5 billion as of September 30, 1994. Of this amount $27.1 billion (57 per cent) was owed to the Paris Club, $14.2 billion (30 per cent) to the London Club $2.4 billion (5 per cent) to the former USSR and other COMECON countries\textsuperscript{45}, and the balance consisted of other government-guaranteed and short-term loans. In 1995 and 1996 however the total cost of debt servicing will only amount to $1.5 - $1.6 billion per year; if no additional debt is contracted, the cost will rise to $2.3 billion in 2000, $2.9 billion in 2002, and $3.5 billion in 2004\textsuperscript{46} The payments - even under the assumption of moderate rate of growth - should be well within the country’s capability.

\textsuperscript{45} The COMECON debt issue was subsequently settled through multilateral negotiations and the cancellation of mutual debts.

5. Direct Foreign Investment

DFI under the communist regime

Prior to World War II foreign capital played a major role in Poland's industrialization\(^{47}\). However, following the communist take-over the government nationalized all privately-owned (including foreign) means of production\(^{48}\) and barred new direct foreign investment.

A small chink in the anti-DFI armor was made in 1976 with the adoption of a Council of Ministers' Regulation concerning the licensing of foreign and Polish-foreign partnerships\(^{49}\). The conditions were, however, far from benign. The Regulation was, technically speaking, not a law and it could be amended or repealed at any time. The tax system was unclear and it was administered in a highly arbitrary fashion. The licenses were issued at the pleasure of the authorities, and the rights of the licensees were severely circumscribed. The partnerships were required to deposit

\(^{47}\) See Wellisz, L. (1938)

\(^{48}\) Rural smallholdings were an exception. Large holdings were broken up into smaller parcels, some (especially in former German-owned territories) were collectivized.

\(^{49}\) Rozporzadzenie Rady Ministrow w sprawie wydawania zagranicznym osobom prawnym i fizycznym zezwolen na prowadzenie niektórych rodzajow dzialalnosci gospodarczej (Regulation of the Council of Ministers concerning the licensing of foreign physical and legal persons to engage in certain types of economic activity) Dziennik Ustaw of 1976, no. 19 item 128
30 per cent of the proposed investment in a no-interest bearing account in a Polish bank and they were barred from receiving credit from Polish banks. The annual rate of profit repatriation was not to exceed 9 per cent of the foreign capital investment plus 50 per cent of the net surplus of direct exports over direct imports.

A series of modest measures adopted in the course of the next decade made foreign investment somewhat more welcome. In July 1982 Parliament turned the 1976 Regulation into a Law thus giving a modicum of security to DFI, though retaining all the restrictive rules. The latter were gradually relaxed. However, during the decade following the introduction of the Regulation licenses were granted only to very small firms formed with the participation of expatriate Polish capital (so-called "Polonia" firms) and the total volume of investment was insignificant.

The first comprehensive foreign investment law, adopted by Parliament on April 23, 1986, swept away all previous regulations. No new licenses were to be issued under the 1982 Law. For a discussion of private foreign investment prior to 1990, see Breitkopf (1950).

50. For a discussion of private foreign investment prior to 1990, see Breitkopf (1950).


(most of the licenses were to expire in 2,000 or in 2,010). Foreign investors gained permission to acquire minority interest in joint stock or limited liability companies. The Law put some restrictions on the fields of activity open to foreigners and on profit repatriation but these were eased toward the end of 1988.

Despite the gradual relaxation of restrictions the volume of foreign investment remained very low till the very end of the communist regime. Total DFI as of the end of 1988 was variously estimated at between $70 and $130 million. According to Breitkopf in 1989 firms with direct foreign participation employed 130,000 workers; of these some 100,000 workers were employed by about 700 "Polonia" firms, while 30,000 worked in the fifty-odd firms licensed under the 1982 law. Enterprises with foreign participation thus gave employment to 0.7 per cent of the 17.5

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53. Ustawa z dnia 22 grudnia 1988 roku o prowadzeniu dzialalnosci z udzialem podmiotow zagranicznych (the Law on economic activities in which foreign enterprises participate) Dziennik Ustaw 1988 no. 41 item 325

54. The low estimate is given by Stanislaw Kubielas (1994a) Breitkopf (1990) gives the high estimate.

55. Breitkopf (1990) states that there were 727 "Polonia" firms; Kubielas (1994a) puts their number at 688. The ephemeral nature of many of such firms and reporting inaccuracies account for the differences in estimates.

56. According to Breitkopf (1990) a total of 52 permits were issued under the 1982 Law; Kubielas (1994) states that 53 enterprises thus licensed operated in 1989.
million labor force, and they accounted for 1.6 per cent of the value of total sales, and 3.0 per cent of total exports\textsuperscript{57}.

1989, the year of transition from a communist to a "Solidarity"-led government, brought further liberalization. The most important measure was the removal of the ceiling imposed on foreign participation. The licenses issued in one year rose to over 800\textsuperscript{58} -- seventeen times the number in the previous two years. 214 of these actually became operational\textsuperscript{59}. The liberalization of the foreign exchange law (December 1990) and the law on privatization (1990) further encouraged DFI.

**DFI since the introduction of the Balcerowicz reforms.**\textsuperscript{60}

Since the introduction of the Balcerowicz reforms, the legal framework for the functioning of enterprises with direct foreign participation has been defined by the Polish Commercial Code of 1934 (as later amended) and by the 1991 Law on Corporations with Foreign Participation\textsuperscript{61}.

\textsuperscript{57} Estimates based on GUS data are given in Breikopf (1990).

\textsuperscript{58} Breitkopf (1990) puts the number at 867; Kubielas (1994) at 814.

\textsuperscript{59} Kubielas (1994)

\textsuperscript{60} The following section is based primarily on Instytut Koniunktur i Cen Handlu Zagranicznego (1994)

\textsuperscript{61} Ustawa o spolkach z udzialem zagranicznym, Dziennik Ustaw, 1991 no. 61 item 253.
Foreign enterprises are required to establish a Polish legal entity to do business in Poland. Exception is made for foreign trade, transport, tourism and cultural services in which foreign firms are permitted to operate directly. Under the 1991 Law foreign investors may invest in corporations and in limited liability companies and they may hold up to 100 per cent of the equity. The Ministry of Finance stands ready to issue, at the request of the foreign firm, a guarantee against loss resulting from expropriation or from similar action.

Foreign investment may take the form of a new enterprise ("greenfield investment") or a joint venture with an existing private or public sector Polish enterprise or finally the acquisition of shares in an enterprise that is being privatized. All foreign persons, whether physical or legal, are required to obtain a government license to acquire real estate. The procedure is complex, and it may be costly and lengthy, thus reducing the attractiveness of "greenfield investment". Permission is also required to form a joint venture with a State Owned Enterprise.

A government license (issued by the Ministry of Ownership Transformation) is needed to engage in the management of harbors and of airfields, real estate brokerage, defence industry, etc.

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62. An investor (whether Polish or foreign) who wants to acquire through the stock market more than a 10 per cent holding in any enterprise is required to make public his intentions.

63. See Taradejna (1991)
wholesale trade imported consumer goods and in the provision of legal services. A license is also required in cases where the Polish partner in a joint venture is a government-owned corporation, and where that Polish partner’s contribution to the joint venture consists of capital in kind. Finally, the permission of the NAP is necessary for establishing a bank with foreign participation. At least one of the directors has to be a Polish citizen. Foreign investors may participate in Polish insurance companies, provided foreign investment amount to at least 50 per cent of the reserve requirements. Note that foreign insurance companies are not permitted to open branches in Poland until 1999.

**Taxation of foreign investment**

Under the 1991 Law foreign investments exceeding 2 million Ecu could be granted tax exempt status for specified time periods if they satisfied any one of the following conditions: (i) the investment was located in an area of structural unemployment; (ii) the investment brought in new technology; (iii) exports amounted to 20 per cent or more of the production.

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64. The Ministry must communicate its decision within two months of the filing for a license.

65. No license is needed if the Polish partner is a fully-government-owned corporation.
Tax relief was granted by the Ministry of Finance on a discretionary basis, creating numerous conflicts and suspicion of corruption. Effective January 1994, the special internal privileges were abolished and all firms, regardless of the origin of capital, are now subject to the same tax laws. However, the machinery and equipment paid for by the foreign partners can be imported duty-free during the first three years of a firm's existence. Foreign employees are subject to a 20 per cent income tax (or a tax specified in a bilateral tax treaty) and they may repatriate their earnings.

The scope and role of direct foreign investment.

Since the collapse of the communist regime the volume of DFI has rapidly increased, its annual inflow having risen from $20 million in 1989 to a peak of $1.5 billion in 1993 (the inflow declined slightly in 1994), and the stock having risen from under $70 million in December, 1989 to over $4 billion in September 1994.

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66. At present profits are subject to a 40 per cent tax; in addition, dividend are taxed at a 20 per cent rate. The tax on dividends may be reduced in accordance with bilateral treaties to eliminate double taxation concluded between Poland and its major trading partners.
In 1994 there was a slight decline in the rate of inflow, but by year-end the total DFI surpassed $4.3 billion.

### Table 6

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<tr>
<td>Number of enterprises</td>
<td>946</td>
<td>1,849</td>
<td>2,649</td>
<td>6,180</td>
<td>8,335</td>
<td>n.a</td>
</tr>
<tr>
<td>Cumulative investment in $(million)</td>
<td>67</td>
<td>180</td>
<td>459</td>
<td>1,408</td>
<td>3,071</td>
<td>4,080</td>
</tr>
<tr>
<td>Investment per enterprise $(000)</td>
<td>71</td>
<td>97</td>
<td>173</td>
<td>227</td>
<td>368</td>
<td>n.a</td>
</tr>
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(a) 1990 -1993 as of December 31; 1994 - as of September 30.

Source: Foreign Trade Research Institute, *Foreign Investment in Poland* (various issues) cited in Kubielas, et. al. (1994)

As Table 6 shows, the size of the average investment in 1989 was under $100,000. Liberalization brought a flood of small-scale Polish expatriate capital. Larger investors came to play a more important role in subsequent years. Though the average size of the foreign holding was still under $400,000 in December 1993, investments of $1 million or over amounted to $2,828 million thus

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67. The PAIZ (the Polish State Agency for Foreign Investment) figures are among the highest of the various estimates of DFI. For a comprehensive discussion of the data issue, see the *Economic Bulletin for Europe* (1994).

68. According to PAIZ investments of $1 million or over amounted to a total of $4,080 million by November 1994. Therefore, investments under $ 1 million amounted to $200 to $400 million.
accounting for over 90 per cent of the total. A major share of foreign investment was located in joint ventures. Typically, foreign investors would initially take a minority share and then enlarge their holdings to assume control. Thus, between 1990 and 1993, the share of foreign holding in joint ventures rose from 40.7 per cent to 72.8 per cent. Industry accounts for 75 per cent of cumulative DFI, and trade for 12 per cent.

How big a role does DFI play in the Polish economy? According to GUS aggregate direct foreign investment accounted for 3.3 percent of all corporate equity capital, as of December 31 1993, and firms with foreign participation for 5.1 per cent. Such firms employed 310,000 workers, that is about 2.1 per cent of the total labor force. However note that foreign presence is growing in importance. In 1991 DFI amounted to some 2.2 per cent of total gross investment; in 1992 to 6.3 per cent, and in 1993 to 11.1 per cent. Estimates of the percentage of investment in

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69. Data on investments of $1 million or more (large-scale investments for short) are collected by PAIZ. GUS gives data on aggregate investment (large plus small-scale). The PAIZ data which are cited here are, however, more detailed (and appear to be more reliable) than the GUS data.

70. Foreign Trade Research Institute data, cited in Kubielas, Markowski and Jackson, op. cit.

71. Calculated on the basis of data given in GUS (1994a) Table 1.4

72. These estimates were obtained by expressing DFI as a percentage of total gross investment in current dollars, estimated by converting the current zloty gross investment figures for 1991, 1992 and 1993 published by GUS (1994) at mid-year dollar-zloty exchange rates.
plant and equipment undertaken by enterprises with foreign capital participation are not fully consistent with the above figures, but they show a similar trend (Table 7).

Table 7

Investment in buildings and machinery, by source (in trillions of zl. at current prices)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>Enterprises with foreign participation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>147.2</td>
<td>1.4</td>
</tr>
<tr>
<td>1991</td>
<td>164.2</td>
<td>4.2</td>
</tr>
<tr>
<td>1992</td>
<td>221.4</td>
<td>9.4</td>
</tr>
<tr>
<td>1993</td>
<td>n.a.</td>
<td>14.1</td>
</tr>
</tbody>
</table>

(C) (B) as per cent of (A)

5. How far is Poland along the road to integration?

In 1988, the penultimate year of the communist regime, Poland was still an almost-closed economy. The ratio of the value of internationally traded goods and services (the sum of imports and of exports) to the GDP equalled only 0.39. Moreover, the Polish producers were shielded from foreign competition. The exporters to the CMEA countries had, what amounted to, a guaranteed market⁷³, while imports of goods competing with domestic products were

⁷³. Most of the highly differentiated products in the case of which quality plays a major role were exported to the CMEA; exports to the West were largely confined to standardized commodities, such as basic chemicals.
strictly controlled. By 1992 the trade/GDP ratio rose to 0.49.\textsuperscript{74} Though the change is not dramatic, it is significant. The change in the character of trade is, however, even more significant. Polish products now have to compete with foreign products at home and abroad. The effects of increased competition are striking, albeit difficult to document: the quality of a broad range of Polish products is rapidly improving, and, in some cases it already matches that of the West.

The integration of Poland in the world economy is largely the effect of the reforms introduced in 1990 - 1991 by the Solidarity-led government. In 1990 hyperinflation was brought under control. The zloty was made convertible and linked to the dollar. Production and consumption prices were freed, and most of the subsidies were eliminated. The economy was opened to world trade and to foreign investment. A treaty of Association was signed with the EEC. There remained, to be sure, much to be done\textsuperscript{75}, but the foundation of integration were firmly in place.

Since 1991 the tempo of reforms slowed down, and in some respects, notably in the area of trade policy, there was retrogression. The question arises whether the initial reforms were not too radical: a more gradual opening up of the economy would

\textsuperscript{74}. Based on IMF data

\textsuperscript{75}. In particular, the debt reduction negotiations were barely initiated.
have given more time for adjustment, hence it might have mellowed the opposition to liberalization. A slower tempo of reform thus might have led, in the longer run, to greater freedom of trade.

There is no doubt that in 1990-1991 Poland suffered a severe trade shock which doubtless contributed to the public's reaction against reform. Gradual liberalization of trade would not have reduced, however, the distress of manufacturing industries most adversely affected by the transition, namely those that were dependent on CMEA or on military orders, or both. On the other hand it may be argued that a mistake was committed by the sudden liberalization of trade in agricultural products. The shock turned the peasants who, under communism, constituted a stronghold of private enterprise, into enemies of reform.

It can be argued, too, that a mistake was made treating liberalization not as a goal in itself, but as a policy tools. Under the Balcerowicz regime customs duties were temporarily reduced or suspended in lieu of currency revaluation - setting a precedent for the subsequent increase in tariffs for fiscal purposes. The 1991 tariff revision presented an opportunity to put into effect a structure that would minimize distortions; instead, the new schedule deliberately took into account the interests of individual branches of industry. Subsequent regimes carried this

76 For estimates of the short-run costs of the dismantling of CMEA, see Rodrik (1992).
policy one step further: import and export controls became a means of winning friends and influencing people.

The retreat from free trade is, however, a passing phenomenon. The degree to which the Polish government can manipulate trade is subject to a strong outside check. Poland is firmly committed to political-economic integration with Western Europe and by the year 2000, Polish industry and financial services (if not necessarily Polish agriculture) will be fully integrated with the European Economic Community.
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