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Theoretical foundation of the stabilization program in Poland

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When I accepted the honor of presenting this inaugural lecture for the beginning of the academic year, I proposed as a subject the review of the theoretical background of the economic policy pursued in our country for the past two years and the comparison between this policy and the economic situation at the present time. I made this choice because I thought that the scientific and at the same time civic reflection on the present state of the economy is now the most important and urgent task. To consider this subject at the Catholic University of Lublin has also a moral dimension—it serves as testimony to the truth.

The state of our economy is such, that in organizing an economic conference a month ago, the Committee of Presidential Advisers had chosen to entitle it, "Polish Economy—The Need for Emergency Plan." We are now reconsidering the results of the same stabilization plan, which two years ago was thought to be such an emergency plan. That program, announced three weeks after a new government was formed in October 1989, was then entitled "The Program of Stabilization and Systemic Changes." After two years not much systemic change has been accomplished, but the stabilization program has been realized consistently, with well-known results.

Obviously it is almost impossible that a complicated program of profound changes in regulations of the whole economy, embodied in several broad parliamentary bills, could have been created at short notice in a few weeks. It was prepared earlier and taken from a rich set of programs of the International Monetary Fund (IMF). What did this program consist of, and what were its main economic prescriptions? Admittedly, some of its elements, announced in the fall of 1989, were reasonable and fit well into the process of transformation of the Polish economy from a centrally planned and socialist one into the market, although yet not capitalist, economy. Those positive measures consisted of further liberalization of prices, restricting or eliminating budget subsidies for many goods and services (started already by the previous government), canceling of the still remaining central directives allocating quotas for the enterprises, and also introducing official convertibility of the zloty by making available to importers the convertible currency earned by exporters. Moreover, there was a prohibition on borrowing from the central bank to cover budget deficits, at a zero interest rate.

But the other elements of the program, although they were at the time accepted by the society, were dubious, and their continuing implementation after the first quarter of 1990 proved damaging. The main slogan of the program was suppressing inflation, which then reached a hyperinflationary double-digit monthly rate, thus interfering with normal life. But nobody explained to the society that this hyperinflation was only partly a result of a budget deficit, financed by the newly printed, unbacked money and a result of the previously existing, huge forced savings, but was mainly an effect of liberalization of prices and of eliminating budget subsidies. It was a necessary "corrective inflation," the cost of abandoning the communist system, and it reached the highest peak of 80% on the monthly basis in the first month of implementation of the program, in January 1990. This inflation had a tendency to diminish since most of the price corrections were realized, and the forced part of savings depreciated by two-thirds because of the past inflation.

The 'fight against inflation'

But it was especially with the slogan of continued fight against inflation, that the stabilization program copied from the IMF portfolio undertook its fiercest attack, ostensibly oriented toward suppressing inflation, but actually leading to suppressing the economy: An extremely deflationary policy was introduced, narrowing and even partly closing the channels by which money flows into the economic system. The

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society was allergic to inflation and desired above all to have the zloty stabilized; therefore the cataclysm which as a result of this operation befell the Polish economy was met with heroic coolheadedness: In one month the production decreased by 31%, volume of trade by over 50%, real wages by 30%, and prices, as I mentioned before, increased by 80%.

How did it happen? A few simple measures were introduced: The interest rate on loans was increased to 38% per month, the wage indexation was permitted to be only 0.3, and the freely convertible zloty was recklessly devalued by setting the exchange rate at 95,000 zlotys per dollar. The consequences were striking, but not as predicted by the government. In the domestic market, the gigantic barrier of demand was created: The industrial firms had no money for working capital and even for wages, the trade enterprises had no money to finance inventories and in effect to purchase the supplies from producers, the consumers did not have enough money to buy finished goods, and producers had no money to pay for intermediate goods.

The enterprises reacted predictably by reducing production; they had inventories of unsold products anyway. There is no enterprise that can keep on producing more than it can sell. The trade firms constrained their transactions, the transportation enterprises reduced the number of connections, the households constrained their budgets, and the real savings decreased to an equivalent of one month's expenditures. Farmers as producers were left with their milk, meat, wheat, and potatoes, they couldn't sell, and those who had taken bank loans discovered that they were bankrupt. The deep economic recession started, and the first half of a million unemployed appeared.

Those developments did not surprise the authors of the program, nor those who implemented it. The results were intended to be, and indeed constituted the core of prescriptions applied to the client countries of the IMF. What was the purpose? The primary purpose was to achieve the external equilibrium of the country, and secondarily its internal equilibrium. Equilibrium is a state when on the domestic market, supply and demand are equal, and in foreign exchange, there is at least a zero or positive balance of trade, and later also a balance of current payments.

This objective was accomplished. The domestic market attained an equilibrium. Production and supply drastically decreased, but it was still enough to match the demand, which decreased even more. Besides, the previously unaccounted-for, exploitative export of food to the U.S.S.R. ended, thus adding to the market supply of food. The waiting lines of shoppers disappeared, and the economy of shortages, which was the core characteristic of central planning and socialism, disappeared.

This represented a tremendous change; the impact was at once felt by everyone, but the economic costs—deep recession—affected mainly the employees of the enterprises struck by the crisis. And because the decrease in incomes was initially compensated by using up previous savings, the people accepted the negative aspects of the market calmly.

Far more important for the program, however, was the attainment of external equilibrium. The high rate of the dollar, three times higher than the purchasing parity ratio and the resulting barrier of demand on the domestic market, led to growing exports and stagnant imports. Enterprises exported everything possible. Surplus on a current payments account grew from month to month and reached in the beginning of 1990 almost $4 billion, which had never happened in the days of planned economy. Obviously this large surplus (deposited at reliable, but low interest rate-bearing accounts in foreign banks) created an additional inflationary pressure: The goods were removed from the domestic market, and the zlotys earned by the exporters to the West were pumped into circulation. The achievement of internal and external equilibrium as such should be evaluated as a positive event for any economy. The question remains nevertheless, if the enormous cost of recession occurred by chance, as a temporary by-product of stabilizing the economy, or if it is an immanent part of the IMF's stabilization program. To answer this question, we should look at the theoretical foundations of those programs.

The advisers from the IMF do not know the reality of the Polish economy and cannot help us. . . . In total, the benefits of having our economy under the control of the IMF consist mainly of some political and psychological comfort.

The issue of absorption

The main objective of IMF programs is to achieve the balance of payments; the theory first identifies the factors which have impact on this balance. Since the balance is structurally determined by income and absorption, it depends on these two variables.

Absorption, according to its definition, is "the sum of expenditures of domestic residents on domestic and foreign goods and services" (or to put it differently: the sum of private consumption, domestic investment, and government expenditures). What is left from the income reduced by the absorption is the net payment balance. Obviously the intent of the program is to have a net that is positive and as big as possible. External equilibrium is thus guaranteed; in the standard IMF notation, we have the following equation:

$CA = I - A$
where: CA = net foreign trade,
I = national income, and
A = absorption.

An unclear and not operational concept of absorption was a weak point of this approach. To make this operational, the Monetarist School proposed a description of the same equation in monetary terms, developing the so-called monetary theory of balance of trade. The market economy is a monetary type of economy, and all changes in real quantities have also their monetary aspect. Monetarists think that the growth of national income is proportional to the growth of demand for money, and the demand for money should in equilibrium be equal to its supply. The supply of money consists of two parts: the stock of domestic money originating in domestic credits (so-called net banking domestic assets) and foreign money, that is, foreign currency reserves. This is described by an equation of differences:

$dM = dR + dD$
where: M = total stock of money,
R = foreign currency reserves,
D = domestic credit.

It follows from the above, that $dR = dM - dD$, so that the increase of foreign currency reserves is equal to the increase of the money stock reduced by the increase of domestic credit.

When we take into account that foreign currency reserves are determined by the balance of trade, we establish by the same token a link between income and absorption theory on the one hand and monetary theory on the other. The increase of the domestic credit is nothing else but our absorption, that is, the spending of "domestic residents," while the increase of foreign currency reserves, that is foreign assets, is just a surplus in the foreign trade balance—the key variable in establishing the equilibrium.

This is what the theory says, in a few purely tautological equations, which are meant to explain "how it is." But the IMF programs rely on the same theory to also prescribe "how it should be." And since the surplus in the balance of trade should be positive and as large as possible, it follows that at the same time absorption should be constrained, which of course means restricting domestic credit. In this way the IMF stabilization program found the variable which it can control, and the theory says, that for achievement of IMF objectives the value of this control variable should be restricted and reduced.

It is only in this context that we may understand why the main attack of the deflationary policy of the government was directed gainst credit activity, not only through the use of drastically high interest rates, but also by application of limits and credit ceilings and by mandating higher obligatory bank reserves. All of that was to diminish absorption. However, the link between the increase of bank credit and absorption is not exact in the post-socialist economy, in which the main role is played by the state-owned enterprises capable of extending mutual trade credits outside the banks. Therefore, the second direction of the attack on "absorption" was directed against wages through a punitive tax on wage increases (the so-called *popiwek*).

The outcome of this radical deflationary policy is that too small a quantity of money is pumped into the economy. The authors of the deflationary program did not understand that a capitalist economy needs more money than a socialist one, because there is no free allocation, and everything must be bought with money, and the full price has to be paid. The deficit of money in an economy which is becoming market-based and capitalist leads to recession crisis and decline.

To see how it happens, we will go back to the already presented absorption and monetary theory of the balance of trade. It is not necessary here to examine the known weak points of the monetarist quantity theory; suffice it to use the equations described above. As usual in the mathematical descriptions of this type, we have here minuend (I), subtrahend (A) and difference (CA), and if the subtrahend is smaller, the difference increases. But this kind of result could not be directly applied to the dynamic economic quantities, which are denoted by the symbols in the equations; the meaning and links between them should be taken into account. Without this it would be only deductive juggling so frequently found in mathematical economics. In this case, the amount of subtrahend, i.e. absorption (domestic credit), affects the magnitude of the minuend, i.e. income, so that

$I = f(A)$.

Constrained absorption (domestic credit) results in diminishing of income, as may be seen in the present recession and decrease of our national income by 12% in the previous year, and by a further 10-12% this year. But the national income (I) is also the source of the surplus in foreign trade, which is a condition of external equilibrium. Decreased domestic credit causes recession and a drop of national income and, through a feedback, hits precisely the foreign currency reserves. Don't the authors and executors of the stabilization program see that?

Yes, they see and understand it. But in defense of their policy, they resort to an argument that is as simple as it is cynical. They contend, namely, that in this situation, the decrease in income will be smaller than the decline in absorption, so that the rest, that is, the surplus in the balance of trade, will still increase. (This is not unlike the well-known and cynical slogan during the Martial Law period: "The government will feed itself.") Moreover, they think that with the decline of national income, it will be easier to reduce the absorption. Thus it pays—from this point of view—to decrease income, driving the economy into recession. This conclusion is clearly formulated in the theoretical basis of the stabilization programs.

We may see from this, that a recession and the deep decrease in national income in the last year and this year (1990 and 1991) has not surprised the authors and executors

of the program, but was intended. The announcements that a boom will come after half a year and that income will drop only by 5%, were deliberately misleading. It is also understandable why the government accepts so calmly successive reports on the second wave of recession, which started in our country after April 1991, when industrial production decreased accordingly by 12, 14, 16, 18, and 22% in September, in comparison with the respective months of the previous year.

The question arises: Why, in most of its programs, does the IMF stress so strongly the goal of restoring external equilibrium, even at the cost of a decline in the economies of the countries implementing those programs? Officially it is for facilitating the development of international commerce, because the trade deficits (just as with big surpluses) make foreign trade more difficult, and as a result inhibit the economic growth of each country and of the whole world economy. This explanation is not sufficient to answer why the IMF is so determined to restrict the absorption, that is, simply to reduce the level of income of the society (60% of absorption consists of household expenditures). This determination of the IMF may be explained by something else: debt repayment. All the countries, for which the IMF provides its "good services" in the form of stabilization programs, are indebted to the large foreign banks, and the surplus in foreign trade gained by the debtors at the cost of their absorption has to go for repayment of debts. This also holds true for the case of Poland. This is the main objective to be achieved.

At present, we see the second phase of diminishing absorption. The first phase saw the violent decline of real wages, social transfers, and a depreciation of savings; in the second, present phase, the incomes of enterprises are being attacked, investment is decreasing below the replacement level, and the state budget has collapsed, so that there is drastic reduction of social and administrative expenditures. Pensions are endangered, the communal investment is at the minimum level. Especially characteristic and "instructive" is the operation with the budget of the state. Since April of this year it unexpectedly happened that the taxes are not being paid in, and there is no money in the budget. A budget deficit appeared, at first small, then growing, and the budget begun to delay various payments. Austerity measures were introduced in education, science, culture, health; there is a discussion about closing schools and hospitals. The budget was modified by the Parliament; expenditures for the Army and police were drastically cut. It is nothing less than a catastrophe.

Who can argue with the 'invisible hand'?

The protests are weak, because the argument that there is no money paralyzes everybody. This argument seems to be as objective as the laws of nature, and nobody can protest against the laws of nature, for instance, against an earthquake. And there is really no money in the budget. In such a way, the previous welfare state and all its public administration were hit at once by the argument of *fait accompli*. Absorption was decreased also in this field, which appeared most difficult to change, since it is protected by constitutional decrees.

Obviously a situation of a budget collapse should have been expected in a situation of persisting recession in the enterprises, which are the main taxpayers. It was not, therefore, an unpleasant surprise, but coolly awaited developments proceeding according to the prearranged scenario.

It is characteristic how differently people react to the poverty created by the present, partly market system, in comparison with their reactions toward the previous, socialist-planning one. Then, there was a concrete responsibility and the concrete addressee of protests against the evil—the state. Now, it seems that only market forces are acting; they are impersonal, so people quietly take the information, that for instance the lack of money makes it impossible for the hospitals to pay for electric power, so possibly they may need to be closed.

The method of diminishing national income has proven very effective in restricting absorption in its most elementary components. After the declarations of the government, that there is no money, nobody asks why there is no money; when the market forces lead to the bankruptcies of the enterprises, it appears only as an invisible hand. But meanwhile, this invisible hand, unlike the proverbial Themis, the goddess of justice, is not actually blind. It acts selectively and purposefully—that is, not objectively—using arbitrarily selected parameters: interest rates, taxes on business wealth called "dividends," punitive taxes on wages, and credit ceilings, directly copied from the central planning system. Those parameters do not result from any market law of supply and demand, but are programmed for suppressing absorption, and in the process they damage the economic potential, prolong recession, and from the thus-suppressed economy extract the surplus in the foreign trade for repaying the debts.

This policy of persisting and deepening recession, the 2 million unemployed, the decline in real income, a crisis in agriculture, is now sharply criticized. Proposals for change are formulated. Answering this, the government defends itself, mainly by referring to the agreements signed with the IMF—the so-called letters of intent, addressed to the IMF, in which detailed Polish obligations are present, describing monetary, credit, and exchange rate policy, fiscal, budget, and income policy, the policy of foreign trade. The form and content of these letters is such, that it means that the sovereignty of the state in the economic sphere is ceded to the IMF. The obligations accepted by Poland in the letters of intent are periodically verified and supervised by the IMF; the Polish government explains scrupulously why there are any deviations in implementation.

The question arises, why this should be so? What do we get in exchange? Obviously, we get specific help in the form of advisers—the officials of the IMF, partly paid by the IMF,

which are here to assist us in market transformations. Next, the IMF supported us in our efforts for a debt reduction. The certifications by the IMF that we are dutifully implementing the stabilization plan, were necessary for the agreement of government lenders to the reduction of our debt by 20%, and conditionally by a further 30%. Backing from the IMF was also necessary, to obtain capital loans of $6 billion. And, at last, the IMF gave us the stabilization loan of $1 billion value to protect the exchange rate of the zloty.

Are IMF advisers worth the cost?

Is it worth it? The advisers from the IMF do not know the reality of the Polish economy and cannot help us. They only monitor the fulfillment of conditions stipulated by the letters of intent. The amount of debt due to government lenders was reduced so far by one-fifth, but for this, we are obliged to start paying interest again, and this year we have to pay in two installments, over $700 million (from the exhausted budget!). Out of the promised new foreign loans, only $200 million were actually obtained, as a result of difficult conditions necessary to use them, but a fee of 1% of the whole amount must be paid annually. Thus, this credit is very expensive. As to the stabilization loan, it was not at all necessary, and is an illusory assistance. In total, the benefits of having our economy under control of the IMF are meager and consist mainly of some political and psychological comfort, that the world-renowned institution assists us in transforming our economy.

This comfort is nevertheless very costly, as this stabilization policy brings us to ruin. The losses that we suffered because of the declining real income can be evaluated in dollars. The national income dropped by 25%, i.e. $40 billion, so it is several times more than what we received not only as real help, but even as promises. For the next year the government anticipates a further decline in economic activity and national income. However, the structure of production and branches of the economy changed only slightly. The recession turned out to be completely unproductive from the mere structural point of view. The structure of property of the economy, except in trade and services, also remained state-dominated.

What can be done, and is it possible to do anything? We have an emergency program for the economy, but we do not have a political setup for its realization. Perhaps the upcoming elections will change the situation. But we cannot rely only on this. We have to turn for help to those forces in the nation with intact authority. The Church is such a force, although it is not by accident that it is becoming now an object of growing attacks. The Church can legitimately voice its views on social and economic issues. The reason for this is the Social Teaching of the Church. In these hard months, we should hear the voice of the Church and its Catholic Social Doctrine: the voice against the crisis and against the policy which led to it.

The IMF and the illusions of 'free market' magic

by William Engdahl

The following is, slightly abridged, a speech to a group of East European parliamentarians and economists on March 7, 1992.

Unfortunately, one illusion prevalent in many countries of eastern Europe is that the International Monetary Fund will help to rebuild the damage of decades of Moscow-dictated imperial economic policy, that the IMF is somehow a "friend" which will help to improve the standard of living and foster industrial reconstruction. This illusion could well destroy the possibility of real improvement in eastern Europe if it is not addressed urgently.

On Jan. 2, the government of Russia imposed what is called "shock therapy" on its economy. Economics Minister Yegor Gaidar followed the program outlined for him by a radical circle of western monetarist economists, led by 36-year-old Harvard Prof. Jeffrey Sachs and Swedish economist Anders Åslund of the Stockholm School of Business. The Russian government proceeded to float prices on most food and other essential goods. According to eyewitness accounts, since January, prices in Russia for critical items have multiplied between 10 to 12 times their earlier "pre-shock" levels.

The program which Sachs demanded of the Russian government was worked out in direct coordination with the demands of the International Monetary Fund (IMF). In their December 1990 special report to the Group of Seven (G-7) on the U.S.S.R. economy, the IMF stated, "Ideally, a path of gradual reform could be laid out . . . but we know of no such path. . . . The restoration of financial stability will require a very sharp reduction in the deficit of the general government . . . absorption of excess money holdings [i.e., confiscation of private savings], a strong freeze on credit creation," and interest rates higher than inflation rates. The IMF report admitted, "Financial stabilization by itself does nothing to establish a market." The IMF demanded that this so-called "stabilization" be accompanied by a "rapid and comprehensive price liberalization" and "rapid progress toward trade liberalization." All this, they admitted, "cannot be implemented without an initial decline in output and em-