Structural Adjustment Lending to Poland: A Window of Opportunity

Poland’s Economic Transformation Program, introduced in 1990, was an unprecedented attempt to stabilize and liberalize the economy while restoring creditworthiness. After decades of central planning, a coalition government had come to power dedicated to a complete reorientation of Poland’s economy based on market principles and integrated into the world economy. The Bank supported the program with a $300 million structural adjustment loan (SAL), approved in August 1990.

When the loan closed in December 1991, the program had halted hyper-inflation, opened Poland’s borders to trade, made the zloty convertible for trade, liberalized most prices, eliminated rationing, privatized small businesses, and made progress in reducing the debt burden. Although output and employment fell by more and for longer than the program’s architects expected, the loan supported the start of a reform process that has been sustained thus far, despite changes in government. Since the SAL closed, marked economic improvements have taken place, led by the private sector.

Major challenges remain, however. Unemployment remains high, some of the largest state-owned enterprises continue to lose money and have not yet tackled reform, and Poland needs a decisive effort to mobilize domestic resources for investments.*

The “big bang” program

The plan’s designers, led by Deputy Prime Minister Leszek Balcerowicz, moved quickly and boldly because they did not know how long the support of the coalition would last. Their approach had two prongs: (1) to stabilize the economy, which was on the verge of hyperinflation, and (2) to create the conditions for a rapid transition to a market economy. To stop hyperinflation and eliminate rationing and shortages, the “big bang,” as the Economic Transformation Program (ETP) came to be called, included lifting most price controls, sharp cuts in producer and consumer subsidies, immediate liberalization of imports, free convertibility of the zloty at a fixed nominal rate (following a massive devaluation), wage indexation below the rate of inflation, and a restrictive credit policy. These measures were complemented by removal of restrictions on private business and elimination of state monopolies.

On the heels of the stabilization package, the authorities initiated far-reaching structural and institutional reforms, which were expected to be implemented more gradually once inflation was brought under control. The main components of these reforms were:

- privatizing most state-owned enterprises (SOEs);
- restructuring remaining SOEs through exposure to foreign competition and through indirect controls, such as taxation and restrictions on bank credit;
- restructuring the banking system and strengthening Bank regulation and supervision;
- establishing an adequate legal framework for private sector development, including introduction of accounting and auditing standards, a clear definition of property rights, and antimonopoly regulation; and
- creating a social safety net to ease the costs of the economic transition for vulnerable people.

International support

The International Monetary Fund (IMF) and the World Bank provided conceptual and financial support for the program. The IMF assisted the economic team in drawing up the stabilization component of the program, while the Bank assisted in the design of the structural and institutional reforms. Financial

*Performance audit report: “Poland: Structural Adjustment Loan,” Report No. 13960, February 1995. Performance audit reports are available to Bank executive directors and staff from the Internal Documents Unit and from Regional Information Services Centers.
Support was promptly made available to back up the zloty: the IMF approved a one-year standby arrangement for SDR 545 million in March 1990, and the leading industrial nations provided a contingent stabilization fund of $1 billion on which the central bank could draw if it became necessary to defend the new exchange rate.

The Bank, in turn, formulated an ambitious country assistance program of 26 loans for a total of $3.7 billion to be approved between 1990 and 1993. The SAL, approved in August 1990, became the main vehicle for Bank-country dialogue. A tranche of $100 million was made available immediately, followed later that year by the release of $200 million as the second tranche. Because the Polish authorities had already implemented the major parts of the reform program, the main goal of the SAL was limited to providing foreign exchange to help strengthen Poland’s reserves, thus adding to the credibility of the stabilization program.

Results

The program transformed Poland’s economy. It halted hyperinflation and virtually eliminated shortages, rationing, and queuing. By the time the Bank’s structural adjustment loan closed in December 1991, Poland’s borders had been opened to trade, the zloty had become fully convertible for trade purposes, and progress had been made in reducing the debt burden. The private sector had expanded beyond the most optimistic projections (see table).

At the same time, early expectations regarding economic growth and the speed of institutional reforms were not fulfilled. But the reform process has been sustained thus far, despite government changes, and since the SAL closed, marked economic improvements have taken place, led by the private sector.

State-owned enterprises

During the SAL disbursement period, fast growth in the nascent private sector was more than offset by sharp declines in the much larger state-owned industrial sector, whose output dropped by a third in 1990-91. Part of this drop was caused by the collapse of trade with the Soviet Union and the Eastern Bloc. But the failure of most SOEs to adjust when the economy was opened to imports contributed to the downturn. Lack of parliamentary support meant a slowdown in enterprise restructuring and privatization; by the end of 1991, only about 12 percent of SOEs had been selected for privatization.

Public finances

The poor performance of SOEs resulted in large tax arrears and nonpayment of bank loans, hurting
government finances and bank portfolios. Public finances were also hit by the mounting costs of social safety nets. Though the government strictly limited discretionary expenditures, local authorities interpreted entitlements liberally, making large numbers of people eligible for old-age and disability pensions.

Poland's inability to meet the fiscal goals of the stabilization program derailed its agreement with the IMF. The overall fiscal balance went from a surplus of 2.8 percent of GDP in 1990 to deficits of 6.5 percent in 1991 and 7.3 percent in 1992—much larger than the program had expected. (Since then, however, several agreements with the IMF have been successfully implemented.)

**Banking sector**

The mounting losses and arrears of the SOEs weakened the portfolios of their creditor banks, placing many of the banks in virtual bankruptcy and delaying the planned financial sector reforms. Forced to capitalize interest arrears, banks could not redirect credit to more profitable clients. Institutional weaknesses delayed the adoption of good accounting and auditing standards, supervision practices, and prudential regulation. Lacking adequate credit management skills, banks followed extremely conservative lending practices, such as demanding excessive collateral from emerging private firms. Since 1993, the Bank has provided support for bank restructuring and recapitalization, with good results.

**Employment**

The drop in output was reflected in a sharp rise in recorded unemployment, from an official zero unemployment in 1989 to 12 percent of the labor force in early 1992. The official number of unemployed at the time of loan closing exceeded 2 million, nearly double what was expected when the SAL was appraised. Jobs in the private sector grew fast, but from a very small base and not enough to offset the losses in the state sector (see figure). The liberal application of unemployment, disability, and retirement benefits hastened the process of job losses.

Though official unemployment figures overstated the problem (by including people who were self-employed or working in the informal sector), unemployment was severe, particularly in rural areas and in small towns where single SOEs had been the main employer. Lack of housing in the large cities—where economic growth was taking place—impeded workers from moving out of the depressed areas.

**Consumption and incomes**

As had been expected, the efforts to stop hyperinflation and to reorient the SOEs resulted in significant hardships. Real wages and private consumption levels fell. (Box 1.) The recorded increases in consumer prices, however, exaggerated the rise in the cost of living, because the base-year prices represented the official, controlled, prices of products that were rationed and sometimes of poor quality. When the economy was opened up, more and better quality products became available, dramatically changing relative prices and consumption patterns. Price indexes do not capture such qualitative changes.

Fiscal constraints forced cutbacks in the provision of health and education services. The elimination of subsidies and price controls sharply increased prices of pharmaceuticals, putting them outside the reach of many. Enterprises reduced day care and other maternal benefits. Women seem to have been more subject to early layoffs than men. (Box 2.) Income distribution became more skewed, as the economic transformation process produced gainers and losers.

**Recent developments**

Since the initial hardships, the private sector has led a broad-based economic recovery that Poland has now sustained for three years. Despite a major drought in 1992, GDP growth has accelerated. Private enterprises now account for more than half of Poland's output and employment. Private consumption is increasing rapidly, as is household ownership of durable goods.

Fiscal policy has improved, strengthened by the introduction of a value-added tax. Monetary policy has remained prudent, and the rate of inflation has been falling steadily, though not as fast as was expected. The government recently
Fort to mobilize domestic resources, the backlog of SOEs that cannot be liquidated is no longer a binding IMF program. Poland needs to make a decisive effort to narrow the external gap needs to be based on the success of any economic transformation program. Although the Polish economic team had a clear vision of what they wanted to achieve, they did not succeed in sharing that vision with the public at large, particularly with political leaders and the business community. Mass demonstrations and widening divisions within the coalition led to erosion of parliamentary support and eventual change in government, making further enactment of reforms difficult.

Building and maintaining political support for reforms is essential to the success of any economic transformation program. Although the Polish economic team had a clear vision of what they wanted to achieve, they did not succeed in sharing that vision with the public at large, particularly with political leaders and the business community. Mass demonstrations and widening divisions within the coalition led to erosion of parliamentary support and eventual change in government, making further enactment of reforms difficult.

Lessons

- "Strike while the iron is hot." The Economic Transformation Program (ETP) succeeded because the government acted swiftly to take advantage of a brief period of wide political support for radical economic reform. Events proved that had the government moved less decisively, the window might have closed.
- Programs like ETP need to be based on realistic projections. The program was overoptimistic about trade volumes, fiscal balance, the growth of output, and employment. As a result, it failed to anticipate and plan for the large increase in unemployment.
- Building and maintaining political support for reforms is essential to the success of any economic transformation program. Although the Polish economic team had a clear vision of what they wanted to achieve, they did not succeed in sharing that vision with the public at large, particularly with political leaders and the business community. Mass demonstrations and widening divisions within the coalition led to erosion of parliamentary support and eventual change in government, making further enactment of reforms difficult.
- A social safety net should be cautiously designed and selectively targeted to ensure that while it safeguards the people most vulnerable, it is affordable and avoids giving perverse incentives. Poland’s excessively liberal unemployment benefits imposed a heavy fiscal burden and weakened the incentives of the unemployed to seek work.
- Decisions on the timing of large disbursements on nonproject loans should take into account the borrower’s fiscal and monetary programs. These disbursements should be coordinated with the monetary authorities, particularly when there is no binding IMF program.

Box 2: Women under the adjustment process

Before the economic transformation, Polish women had easy access to education and jobs. State-owned enterprises (SOEs), the largest employer in the country, provided child care facilities and offered generous leave and other benefits to facilitate the employment of mothers with young children. In addition, retirement age for women was five years earlier than for men, making home care of children by older female relatives easier. The participation rate of women in the labor force was high by international standards.

The transformation program put SOEs under pressure to reduce losses, sell assets, and cut costs. Child care facilities were either closed or sharply curtailed. Women were the first to be laid off and the last to be hired to reduce the cost of maternity leave and other benefits. In 1993, only 23 percent of job openings in the government were for women; 77 percent were for men.

Lack of housing in growing areas makes it particularly difficult for mothers with young children to move from depressed areas to areas with more employment opportunities. For fiscal reasons, the authorities are considering raising the retirement age for women. Such a measure will make it harder for working mothers to arrange for child care. The rapidly growing informal sector may offer brighter employment prospects for women.

Not only to narrow the external gap but also to finance its massive investment needs.

In the financial sector, the reforms need to be extended to the public specialized banks, notably in agriculture and housing finance, which continue to experience severe portfolio problems. The management of the public investment program needs to be strengthened, by prioritizing projects and stimulating private sector participation.

Given the vitality of the emerging private sector, the reforms supported by the ETP are likely to be sustained. But persistent high unemployment, much of it concentrated in depressed regions, threatens to undermine political support reform. Strong political support will be essential to put Poland on a sustained growth path. Prospects for sustaining the benefits of the reforms accomplished thus far will be enhanced if the government accelerates the privatization of SOEs, enforces more strictly the restructuring of SOEs that cannot be liquidated or privatized, and maintains sound fiscal and monetary policies.

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