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Hubert Gabrisch\*

# Restoring the Growth Potential of Formerly Centrally Planned Economies

*All formerly centrally planned economies record very substantial declines in their social products. The largest drops in production are recorded in Poland and in east Germany (the former GDR), that is, in those countries where the most radical steps towards a market economy were taken in 1990. Thus it looks as though a recession was unavoidable during transition. But what are the conditions that must be fulfilled in order to restore growth potential to these countries? The following article aims first to devise a theoretical picture of a successful transition. The criteria thus obtained are then employed for an analysis of the recessive processes in Poland, the first east European country to start a radical programme of transition. Finally, the recession in Poland is compared with that in the former GDR.*

Systems in which economic activities are coordinated by markets are as a general rule distinguished by capacity reserves, so that the actual gross domestic product (GDP) is lower than the potential; they are demand constrained economies. This fact enables market economies to react flexibly to changes in the level and structure of demand. Besides, that situation facilitated the transition from a (capitalist) market economy to a (socialist) command economy.<sup>1</sup> Today, conversely, the transition from command to market economies is impeded by the near exhaustion of reserves, because planned economies are characterized – even in the completely incorporated sectors – by full employment, though not by efficient use of all resources; they are supply constrained economies.<sup>2</sup> Therefore one of the foremost tasks of the economic policy of transition is the restitution of these reserves and thereby the restoration of the flexibility of the production facilities. That necessitates a recession, i.e. a decrease in the inefficient production of goods and simultaneously the displacement of all the means of production and labour involved.

But it is of decisive importance, if and when and how free resources are again (and more efficiently) put to use; for only then may we speak of the economy's restored growth capability. But of course that does not mean that all resources are employed again: for in that case the economy's flexibility would not be secured.<sup>3</sup> The foremost three prerequisites needed for re-employment would appear to be: restructuring, competition and stabilization of the economy.

We must distinguish between the inefficient sector and the efficient sector of the economy: the inefficient sector, which in eastern European countries, as a rule, is the state sector and which absorbs about 80-90% of resources, capital and labour, usually shows lower productivities than the efficient sector, which mainly consists of the private and the foreign sectors. This does not mean that in the state sector there are only poorly operating plants. We can find large differences in efficiency; as a rule, more efficient plants are to be found in consumer goods industries. The laying-off of labour and the closing down of obsolete installations would result in a rise in productivity in the originally inefficient sector. The restructuring process is in any case concluded when productivities are equal in both sectors. Thus it is the first condition for a restoration of growth capacity that the increase of production in the efficient sector must be greater than its decline in the inefficient sector. Failing that,

<sup>1</sup> This transition took time, and it has hardly been completely finalized. Residues of the private enterprise system existed everywhere (e.g. in Poland almost the whole rural economy), and with it free market coordination. In the GDR this transition was carried almost to the limit by the last wave of expropriations at the beginning of the 1970s, which eliminated small and medium-size private enterprise. It seems that in socialist literature that transitional phase is often referred to as the "phase of extensive acting". The required "intensification" means that the last reserves left over from extra planned-economy activities were exhausted. And thus we find the problems of "intensification" making their appearance in the literature of the planned economy at precisely the stage when extensive expropriations had left ever fewer aggregate economic reserves and thus minimal flexibility.

<sup>2</sup> As pointed out by K. Laski: Concepts of Transition in Socialist Economies, paper presented at the Workshop on East-West European Economic Interaction, Tübingen, 10-14 October 1990.

<sup>3</sup> In practice it means that a modicum of unemployment is unavoidable; which can be socially acceptable only if it is a matter of temporary unemployment.

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the transformation process may end in stagnation with increasing unemployment because, due to the productivity relations, if production declines then more labour becomes redundant in the inefficient sector than can be absorbed by the efficient sector.

If this process is to be controlled by the market, then hard budget constraints and competition must exert a permanent compulsion – by threatening the existence of the enterprises if they persistently pile up losses – to minimize costs and maximize profits; and thus ruthlessly compel them to invest, to innovate, to take risks and to show great flexibility.

## Competition

A long period of time is needed for the development of truly competition promoting market structures (existence of numerous autonomous enterprises of all sizes, competent owners and managers, responsibility, profit-making orientation, risk readiness), probably longer than it took for the transition from the market economy to the command system, during which these structures were destroyed. Even an economy that is macro-economically demand-constrained may be micro-economically insufficiently flexible, with the consequence that the well-known free-market control mechanisms – especially free prices – cannot function according to expectation. A decline in demand may lead to recession, but since competition is missing, the price mechanism exerts no compulsion to cut costs, or to increase productivity, to modernize and re-structure. A subsequent rise of demand would not lead to a rise in productivity and to the improved utilization of capacities (quantity adjustment), but to price increases (price adjustment), i.e. to a reaction which in a fully functional free market economy would, in principle, be expected under fully utilized capacities.<sup>4</sup>

Even a reconstruction of the state sector would, in principle, make no difference, much as that would seem necessary and possible. True, the productivities might be raised by the release of redundant resources, but that would not automatically implement competitive behaviour.<sup>5</sup>

To allow the process of reconstruction to proceed as desired, it is necessary to take steps towards creating structures to promote competition. A central role among

such steps is played by the promotion of private enterprises (abolition of all restrictions) and the privatization of the state enterprises.

## Privatization

In the recent debate on privatization in eastern Europe it is not always expressly said that the aim is the restoration of the entrepreneurial functions – risk-taking, responsibility, profit-making orientation – in order to make economic activities efficient. Frequently privatization appears to be an end in itself, to be reached as quickly as possible. There exist two short and medium term obstacles to rapid privatization: first, the creation and development of an entrepreneurial elite, as distinct from the speculative trends and adventurism now so often encountered in the private economy in eastern Europe,<sup>6</sup> which is not only an economic but also a social and ethical learning process which is bound to take considerable time. Second, the privatization of state enterprises encounters numerous economic problems, significant among them especially the prevailing slight interest in the taking over of – or acquiring a holding in – large enterprises, most of them in need of capital reconstruction. That lack of interest is due to the fact that people are not used to save by means of investment in securities; it is compounded by the lack of confidence of the population in any kind of state-sponsored saving. People in the formerly socialist countries are interested in saving mainly in tangible, physical assets (weekend houses, motorcars etc.). The experience of hyperinflation during the transition to a free market economy may well cause a trauma in those who for decades had made use of the (few) available official forms of saving, and it could also, for a long time to come, destroy their willingness to invest their money in equities instead of physical goods.

In addition, the fact that the know-how needed for the reconstruction of state firms does not exist, but must be imported – in the ideal case with foreign capital – constitutes a problem. With the exception of the new eastern German Federal states (former GDR), which can have recourse to the experience of west German managers and who now enjoy a relatively large capital flow, especially from west Germany, the prospects and prerequisites are rather poor. As a consequence of the restriction of capital inflow from the West based on popular, or nationalistic, arguments and basically hard to understand, these countries are reduced to resorting to the meagre domestic sources of capital and domestic – albeit barely existing – know-how in tackling privatization.

It is against this background that the idea of bestowing the state capital as a gift to all citizens in order to accelerate

<sup>4</sup> Cf. M. Bhaduri: *Makroökonomie*, Marburg 1988, pp. 46 ff.

<sup>5</sup> Otherwise the most important argument in favour of privatization would fall away.

<sup>6</sup> Cf. J. Kornai: *The Affinity between Ownership and Coordination Mechanisms*, lecture delivered in Moscow, March 1989.

the process of privatization is much under discussion, especially in the CSFR and in Poland. But it is a method that can hardly much enhance the prospects of growth:

□ To make a present of the state's assets would not even procure the capital needed for replacement investments, not to speak of the means required for reconstruction over the next few years.

□ Nor will a free gift of assets be able to awaken the awareness that goods in short supply have their price. Hence, giving things away can hardly be expected to produce that entrepreneurial initiative that is so very much needed.

### Import Competition

Even an economy dominated by monopolistic state enterprises can become exposed to competition comparatively quickly – namely by import competition. Liberalization of trade, the introduction of – though initially restricted – convertibility of the national currency and the fixing of an appropriate exchange rate are the necessary instruments. It is frequently argued that a massive

“devaluation to a level far below the country's technical productivity” (a circumlocution for undervaluation) is unavoidable if foreign trade equilibrium is to be achieved.<sup>7</sup> But an undervaluation can also constitute a protectionist measure, with which the existing industries (structures) can be shielded from external competition. Lipton and Sachs, it is true, attempt to describe the circumstances under which a devaluation of the currency would lead to an increase of exports and imports,<sup>8</sup> but that model functions only on condition that the additional incomes of the export sector are immediately devoted to more domestic production (or investment) and rising import demand and do not increase enterprises' savings. However, because import demand is a function of real social product and higher profits are first saved before being invested or otherwise consumed, this model will not work for an economy in decline.

### Stabilization

Averting hyperinflation, somewhat inexactly but more generally termed stabilization policy, is a further prerequisite. The danger of hyperinflation is a very real

<sup>7</sup> Cf. e.g., L. Stankovsky: Probleme der Außenwirtschaft während der Übergangsphase in Osteuropa, in: Wifo-Monatsberichte, 10/90, pp. 565ff.

<sup>8</sup> D. Lipton, J. Sachs: Creating a Market Economy in Eastern Europe – the Case of Poland, Brookings Papers on Economic Activity, No. 1, 1990, pp. 75-133.

## PUBLICATIONS OF THE HWWA-INSTITUT FÜR WIRTSCHAFTSFORSCHUNG-HAMBURG

Rasul Shams

### INTERESSENGRUPPEN UND ANPASSUNGSKONFLIKTE IN ENTWICKLUNGSLÄNDERN

#### Fallstudie III Jamaika

At the HWWA-Institute case studies are being conducted within the framework of a research project supported by the Deutsche Forschungsgemeinschaft (DFG), which are intended to enable statements based on empirical data to be made regarding the extent to which the conception and implementation of adjustment programmes tends to reduce or sharpen conflicts.

The studies are based on the assumption that the success or failure of the adjustment programmes is determined decisively by the activities of interest groups. This third case study deals with Jamaica, which as a small island economy is particularly suited for an exemplary examination of the usual arguments regarding the conflict potential of adjustment policies. (Only available in German.)

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one, since overall economic demand exceeds the potential supply, and since – in an economy without functioning markets and with a strongly endogenous money supply<sup>9</sup> – price decontrol can lead, not to a once-only price rise balancing supply and demand, but to a steady price increase. Therefore demand must be skimmed off, the state budget constraints of the state sector (enterprises vs. government vs. central bank etc.) must be stiffened. But when such a policy of demand restriction is pursued, one must be aware of the intensifying and restraining economic correlations operative in a demand constrained economy. We can estimate the recession by a simple model based on the theory of effective demand. To repeat: in a supply constrained economy the factual GDP corresponds to the potential, meaning that capacities are fully utilized and there is full employment. In a demand constrained economy the GDP rarely attains the limits of the potential GDP, but usually remains below. Under such circumstances savings of households and firms  $S$  is identical to investment of the enterprise sector  $I$ , the deficit in the state budget  $D$  and the export surplus  $E$ :<sup>10</sup>

$$(1) S = I + D + E \text{ and/or } (1a) \Delta S = \Delta I + \Delta D + \Delta E$$

This equation does not say anything about the impact direction, but – according to the theory of effective demand –  $I$ ,  $D$  and  $E$  determine domestic savings, and not vice versa.

A decline of demand leads to a decline in production. The extent of the decline is determined by a multiplier process, where the savings ratio =  $S/Y$  plays the central role. Simplified,

$$(2) \Delta Y = 1/s * \Delta S$$

holds good. Yet there are several stabilizers and de-stabilizers to be considered: when the exports are more or less determined by the volume of the external markets, while conversely a decline of  $Y$  lessens the imports, then a tendency to an increase of  $E$  will appear. A decline of  $Y$  could also cause the state's net receipts  $T$  to decline (tax receipts fall, expenditures for unemployment benefits rise) causing a tendency to a budget deficit to arise, even when the government aims at a balanced budget. Finally,

concerning the savings ratio: equation (2) holds only for a constant savings ratio. In the case of an external shock or a fundamental change in the system  $s$  can hardly be assumed not to change at least in the short term. Given simultaneous change, the following logarithmic inference of  $\Delta Y = 1/s * \Delta S$  holds good:<sup>11</sup>

$$(3) \ln Y = \ln I - \ln s + \ln S \text{ or } \Delta Y = Y(\Delta S/S - \Delta s/s)$$

Equation (3) differs diametrically from equation (2): given constant national savings  $S$ , an increase of the savings ratio causes  $Y$  to increase; given a simultaneous change of both magnitudes an increase in  $s$  acts as a restraint.

As mentioned above, in the formerly socialist countries it is not only necessary to reduce demand to the level of the potential supply to avoid hyperinflation but even to a level below that supply to make the production mechanism flexible. However, this condition is not sufficiently precise. Rather, it is decisive that the reduction of demand should affect the non-efficient sector, because there the surplus resources are to be set free. Conversely, the demand stimuli for the efficient sector should be positive to encourage the (new) entrepreneurs to increase their output, to invest and thus to absorb and employ the resources set free in the inefficient sector.

### Dilemma

Thus the stabilization policy required in the countries of eastern Europe faces a dilemma: on the one hand it faces the task of limiting demand, and on the other a reduction of the overall level of demand can also involve a demand shortfall in the efficient sector, thus impairing the economy's overall growth potential. The efficient (and mainly private) sector of the eastern European economies is concentrated on the production of consumer goods and services, and a policy of demand restriction by reduction of private households' incomes would therefore hit this sector comparatively harder than it would hurt the inefficient sector. The result would be a protracted period of stagnation, high unemployment and pauperization of the population. In other words: that stabilization policy would fall into the *recession trap* (Laski). The government should, at any rate, base a sound stabilization policy on reflections about the acceptable lower limits of a recession.

But there is also a *devaluation trap*: a deep recession would lead to separation from the world economy if and when it is accompanied by a currency devaluation to an

<sup>9</sup> This endogeneity is also enhanced by a banking sector that is quite inadequate for free enterprise processes.

<sup>10</sup> We can derive (1) from  $Y = L + P + T = C + I + G + X - M$ , demonstrating that the domestically, in the form of wages  $L$ , enterprises' profits  $P$  and state net receipts  $T$  (taxes minus subsidies and social transfers) produced incomes  $Y$  can be used for households' consumption  $C$ , state expenditure for goods and services  $G$ , investments of the enterprises' sector  $I$  and for net exports  $(X-M)$ . Since wages and profits are used for consumption and savings, we can write  $S + C + T = C + I + G + X - M$ .  $G - T = D$  (budget deficit),  $X - M = E$ , hence:  $S = I + D + E$ .

<sup>11</sup> Only for small changes. For larger changes we have to use another equation.

undervaluation level. In that case a decline would set in, not only of the overall level of demand (due to recession), but also of demand for imports in particular, because the devaluation makes them dearer relative to domestic products. Such a measure is originally intended to turn the external deficit into a surplus. But it would be fatal were one to assess that situation as a positive factor for an economy in transition, even if the country is deep in debt and has for years failed—as, for example Poland has done—to service its debt. A turn-about in the balance of trade has no other meaning than that a net resource inflow has turned into a net resource outflow. The desired disengagement of resources at home due to the recession is then accompanied by an outflow of resources out of the country, and the intended flexibilization of the production apparatus does not take shape. Under these circumstances aggregate savings may even increase, but they do not flow into investments in the efficient sector: they merely benefit the outside world.

Summarizing our foregoing considerations we come to the following conclusions:

- ☐ The restoration of the growth and development potential will depend in the first place on whether the necessary restructuring process towards an efficient, predominantly private and foreign financed sector can be launched successfully.
- ☐ But restructuring alone does not suffice. A growing readiness of households and enterprises to save the bulk of their (if possible supplementary) incomes, and to change from saving in tangible (physical) assets to saving in financial assets (bonds, equity etc.), is of decisive importance.
- ☐ The efficient sector must have, and be able to perceive, prospects of adequate and profitable investments, which in turn depend quite definitely on the prospective market volume. Stagnating, or, worse still, declining demand would weaken such prospects.
- ☐ In the transition from the supply constrained to the demand constrained economy any drain of the aggregate savings (the released resources) – their flowing abroad – must be avoided, since otherwise the investments that are essential for growth potential (flexibility) cannot be achieved.

We shall now apply these theoretical considerations to the transitional policies in Poland in 1990.

## Poland's Transitional Programme

Among eastern European countries Poland was the first to start a radical programme of transition. The programme

is a combination of measures aimed at transforming the centrally planned system into a market economy and at stabilizing the economy within the next two to three years.<sup>12</sup> The main points of the system change are:

- ☐ the establishment of property right structures as in western industrialized countries, which means privatization of state-owned enterprises and promoting private firms in services and small-scale production, foreign direct investments;
- ☐ the existing state-owned enterprises will operate more independently in the economic as well as the legal sense;
- ☐ promotion of competition by an anti-monopoly policy and by freedom of establishment for new firms;
- ☐ simplifying the bankruptcy procedure;
- ☐ re-structuring the finances of the state, particularly reform of the tax system;
- ☐ continuing reform of the banking system and of the basis of money and credit policy;
- ☐ establishment of a capital and a labour market.

The IMF sponsored stabilization programme includes the decontrol of price formation except for the prices of coal, coke and electricity and prices for some services (flat rentals, communal services and transportation rates). Coal, coke and electricity prices (amounting to about 5% of the price index) were administratively raised to a level covering production costs plus a certain margin of profit: the coal price by 400% in wholesale trade and 600% in retail trade, the price of electricity by 300%.

The 1990 state budget was to be balanced. Almost all price subsidies, even for basic foodstuffs, were abolished. Some non-price subsidies (e.g. for housing, transportation services) remained. Tax redemptions for exports were to be eliminated; import customs were to be used to cover budget outlays in general, and not, as hitherto, especially for subsidizing exports. Up to the end of 1990, no new central investments were to be started, and some projects in progress were to be stopped.

To make money scarcer a positive real interest rate was to be established. In January 1990 the nominal interest rate for refinancing credits of the National Bank was set at 36% monthly (higher than the average inflation rate expected for January-February). Enterprises which did

<sup>12</sup> The sources employed here are: Programm gospodarczy. Głównie Założenia i kierunki, Warsaw, October 1989; "Założenia polityki społeczno-gospodarczej na 1990r", in: Rzeczpospolita, December 15, 1989, pp. 5 ff; and, above all, the Letter of Intent of the Polish Government to the IMF, partly published in Rzeczpospolita, December 28, 1989, p.3.

not obtain bank credits or were not willing to meet their obligations vis-à-vis other enterprises were to go bankrupt. The establishment of new banks including those with foreign capital shares was to be promoted.

A uniform rate for foreign hard currency was introduced per January 1, 1990. At the same time the zloty was devalued by about 50% to 9500 zlotys per US dollar. All firms were obliged to sell their hard currency earnings to banks, but they also had the right to buy foreign exchange for imports from banks. Private persons were permitted to buy foreign exchange to cover their "obligations in these currencies". The central distribution of foreign exchange, foreign exchange auctions and foreign exchange accounts (except for private accounts) were abandoned. The introduction of internal convertibility was accompanied by the abandoning of all quantitative import restrictions and by a strict limitation of the list of goods needing an export licence.

As it was feared that the freeing of most commodity prices, the raising of interest rates and the devaluation of the zloty would boost inflation in the case of a supply constrained economy, the programme set two anchors for cost and demand control. The first was the control of wage increases. Aiming at nominal wage increases below price increases, a special tax on over-normative wage increases was introduced to be paid by the firms. If the wage increase did not exceed 30% of the increase in the price index in January and 20% in February and March (this coefficient was changed in later months), the firm's wage fund was free of tax. If wage increases exceeded these margins by two percentage points, a tax of 200% on the additional payment was to be paid, by more than two percentage points a tax of 300-500%.

The second anchor was the stabilization of the foreign exchange rate for at least three months (it has remained practically unchanged up to now). The stability of the officially set rate was to be defended by the National Bank by using a stabilization fund of US\$ 1 billion established by Western governments and to be restored by the end of 1990.

According to the plan the rate of inflation from December 1989 to December 1990 was not to be higher than 95% (against 650% over the preceding period). The anticipated decline of GDP was about 5%; this estimate has not been published but taken into account by officials preparing the plan. Unemployment was estimated at a level of about 400,000 persons (3% of total employment).

In foreign trade in convertible currencies, at constant exports, an increase in imports of about US\$ 1 billion was expected, thus changing the small export surplus in the trade balance of the last year into a deficit of about US\$ 800 million in 1990. There was no estimate for investments of the enterprise sector in 1990, but it was generally admitted that they were likely to decrease.

This radical stabilization programme turned the supply constrained Polish economy still prevailing in 1989 into a demand constrained economy; we may try to evaluate the depth of the recession by means of a model based on the above described principle of effective demand.

### Character of the Recession

In 1989, Poland's GDP was estimated at about 10.500 billion zlotys at constant 1985 prices. Investments I amounted to 3.200 billion zlotys, the state budget deficit D to 0.800 billion zlotys (8% of the GDP!) and the trade balance surplus E to 0.060 billion zlotys. Savings (I + D + E) were at about 4.100 billion zlotys and the share of savings in GDP at about 38.9%. Let us assume that investments would decline by 10% resulting in  $\Delta I = -0.3184$  billion zlotys. Further, the export surplus of the stabilization plan is negative (-0.2 billion zlotys), thus the expected decline of the export surplus in 1990 would amount to  $\Delta E = -0.2 - 0.060 = -0.260$  billion zlotys. And lastly the basic assumption of the plan is the balancing of the government's budget; this means a reduction of the deficit by  $\Delta D = -0.800$  billion zlotys. Together we get an expected reduction of savings in 1990 of  $\Delta S = -0.3200 - 0.260 - 0.800 = -1.400$  billion zlotys.

If the share of savings  $s$  in 1990 were the same as in 1989 we could estimate the decline of GDP using equation (3) and we would get  $\Delta Y = (1/0.389)(-1.400) = -3.600$  billion zlotys or a relative decline of about 35%. Of course, if the decline of the GDP were to entail a decrease in tax revenues and an increase in expenditure for the unemployed, the state budget would show a trend toward a deficit. Moreover, with declining GDP the propensity to import will decrease and there will be a trend towards a surplus in the trade balance. It must be noted that our early<sup>13</sup> estimate is the evaluated combined result of the measures foreseen in the stabilization plan; it shows a much deeper recession than originally expected by the plan.

The data on economic performance in the first half of 1990 more or less confirm these estimates. Production by state industry dropped by 28% against the first half of 1989, to be compared with the 10% decline expected by the stabilization plan. Though monthly inflation dwindled down from about 80% in January to about 3% in June, price

<sup>13</sup> It should be noted that this is not an *ex post* analysis. It was made for the first time by K. Laski in February 1990 – *ex ante*, with the same results; see "Pulapka recesji", in: *Zycie gospodarcze*, March 4, 1990, pp. 1 and 4.

increases could not be brought down to the desired level. Originally the government expected an 82.5% increase of consumer prices in June against December 1989, or 10% per month on average. In fact, the average rate of inflation during the first half of 1990 amounted to 18.6% per month. Investment dropped by 13% in real terms, and in foreign trade the surplus in trade in convertible currencies increased to US\$ 2.3 billion (that means that E as a share of S increased). The state budget recorded a surplus of only about 3% of GDP after a deficit of 8% of GDP in 1989 – implying that the impact of the GDP decline on the state budget's incomes (T) and expenditures can be neglected.

The policies of curbing demand seem to have fallen into the recession trap. The consumer industries recorded the most excessive decline of sales: light industries –40%, food processing –37%. Sales of metallurgy dropped by only 18%, of electro-engineering by 24% and of the chemical industry by 26%. Taking into consideration the structural problem of each centrally planned economy, namely the weakness of final production above all in consumer and export oriented branches, and the too highly developed "production for production", the structural results of the Polish stabilization plan are not very promising.

The economic situation did not develop too favourably for the private economy either. In 1989 the number of enterprises (taking account of liquidations and closing-downs) increased by 230,000; among the newly established firms 32% operate in industry (including handicraft), 19% in services and 17% in trade only. After eight months of 1990 the number of private enterprises had increased by only 54,000. The number of enterprises active in the handicraft sector even declined by 35,000. Also in the service sector the development was negative. In trade 139,000 firms were newly established, 18,000 were liquidated, and 15,000 were closed down.<sup>14</sup> The fact of prospering trade indicates the enormous increase of speculative trends in the private sector, caused by the deep recession.

It seems that policies also fell into the devaluation trap: the Polish economy suffered from a severe net resource outflow and, caused by a severe import contraction, total imports fell by 33% while exports increased by only 3.3% in real terms. In both directions, convertible currencies and non-convertible currencies, huge exports surpluses (E) were recorded, but this unexpected development – acting

as a buffer concerning S and Y – narrowed the very domestic flexibility that should be restored by the recession.

Assuming that trends of the first half will prevail in the whole year 1990 and that the savings quota s were to remain unchanged, Y would drop by about 22.5%. Private consumption would bear the main burden of the recession. In foreign trade, the surplus in hard currencies would reach almost US\$ 3.5 billion.<sup>15</sup>

### Comparison with East Germany

Excepting Poland, only the former GDR had to submit to a similarly severe recession – and that after the introduction of currency union. It might therefore be revealing to compare the causes and the types of recession and to draw relevant conclusions. In both countries demand for domestic products collapsed: in Poland after January 1, 1990, in the former GDR after currency union on July 1, 1990. But whereas this happened in Poland due to the rapid collapse of real incomes, its cause in eastern Germany was not a result of shrinking incomes, but rather the outcome of a process of substitution, with western goods replacing east German products.<sup>16</sup> There the cause was the currency union, with its exchange rate of 1:1, bringing in its wake a de facto revaluation of the GDR's currency (of about 400%). In Poland, incomes were in fact depreciated (the zloty by about 50%). Thus the GDR revaluation protected the public's incomes and demand, while exposing the enterprises to world market competition, subjecting them to an enormous adjustment pressure, which is only partially and temporarily compensated by transfer payments from west Germany. In other words: the recession in the former GDR is connected with an enormous modernization and restructuring pressure (*recession by adjustment*), but in Poland, conversely, solely with a decline in incomes. The absence of external and, of course, domestic competition precludes the recession being accompanied by any stimuli towards modernization (*recession by inertia*). Of course, the real revaluation in the former GDR was possible only thanks to appropriate financial assistance from the FRG, against which the US\$ 1.8 billion made available to Poland by IMF and western governments to support an exchange rate of 9,500 Zl/\$ appears modest in the extreme; but that is no argument in favour of an elimination of import competition by undervaluation of the zloty.

The conclusion to be drawn appears to be this: that an undervaluation of the currency may be a cul-de-sac for formerly centrally planned economies that are on the road to becoming market economies and which are burdened with tremendous structural problems.

<sup>14</sup> Cf. Rzeczpospolita, September 28, 1990, p. 1 (supplement).

<sup>15</sup> A relaxation of incomes policies fostered a slight recovery in the second half of 1990. Hence, GDP did not drop so drastically but by about 15-17% only.

<sup>16</sup> A fact emphatically stressed in the autumnal experts' report of the five large economics institutes of October 18, 1990, p. 24.