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Zbigniew Polański*

The Financial System in Post-Communist Countries: the Polish Lessons

The financial systems inherited by post-communist countries are damaging their economic development and make impossible macroeconomic policies aimed both at growth and economic stabilization. This incompatibility is illustrated by recent Polish experiences under both the last communist and the first non-communist government.

The dramatic social, economic, and political events that are taking place in Eastern Europe have still not produced substantial modifications in the structure and performance of their financial systems. The rudimentariness of the financial sector continues to be one of the main characteristics of the general absence of a market infrastructure. In economic theory, however, the significance of financial markets, banks and other financial institutions in the economic development of market economies is often stressed.¹ The increase in the importance of financial institutions during the transition to a market economy is obvious if we realize that money and finance are essentially a substitute for economic centralization.²

The workings and structure of the communist economy were the effect of an attempt to build a system based on the direct management of physical resources. Its functioning was founded on bureaucratic regulation, which in turn was strongly linked to state ownership of the means of production.³ As a result, the financial system and monetary flows were assigned virtually no functions other than passive accountancy and the control of the real economic processes taking place within state-owned enterprises.⁴

The role assigned to the financial system had a decisive influence in shaping its institutional framework. The financial system had a very simple structure: its main part – the banking sector – was based on the idea of a monobank, i. e. an institution which performed the functions of both commercial banks and a central bank. Of

course, in practice in every communist economy there was more than one banking institution. Nevertheless, the basic principles of the monobank idea were always preserved. The banking system worked on a one client – one bank principle, the activities of every bank (and even its branches) were strictly assigned to specific spheres of the economy and, therefore, no competition existed.

The absence of factors which could stimulate the development of financial markets led to a very restricted variety of financial assets in the economy. Essentially, the only financial asset was money, in the form of cash and deposits (book money). There were no other financial assets which were both domestic and legal at the same time.⁵ As a result, the finances of state-owned enterprises were based on three sources: internal accumulation (income from sales of products and services), budgetary subsidies and bank credits. The proportions of funding from these three sources changed from country to country and over time. Nevertheless, the current functioning of enterprises was always based mainly on working-capital bank credits.⁶ In order to make the enterprises more dependent on bank control state-owned enterprises were

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¹ Cf. e. g. Joseph A. Schumpeter: *The Theory of Economic Development*, Harvard University Press, Cambridge 1934; John G. Gurley and Edward S. Shaw: *Money in a Theory of Finance*, The Brookings Institution, Washington, D. C. 1960; Maxwell J. Fry: *Money, Interest, and Banking in Economic Development*, Johns Hopkins University Press, Baltimore 1988.

² Cf. John G. Gurley and Edward Shaw, op. cit.

³ Janos Kornai: *The Affinity Between Ownership Forms and Coordination Mechanisms: The Common Experience of Reform in Socialist Countries*, in: *Journal of Economic Perspectives*, 4 (3), pp. 131-147.

⁴ For convenience I shall use the expression "state-owned enterprises" interchangeably with "enterprises from the socialized sector" and "socialized enterprises" (the last two terms also include cooperative enterprises).

⁵ In practice, however, there often existed quite sizable foreign assets (e.g. private foreign currency accounts) as well as illicit assets (e.g. trade credit which developed between socialized enterprises).

given an inadequate quantity of money to run current production without the use of bank credit.

The absence of financial markets and commercial banks also resulted in a lack of economic (non-administrative) instruments for controlling the money supply. It was possible (at least to a certain extent) to decelerate the rise in the money supply only by administrative (bureaucratic) methods such as the imposition of ceilings on bank lending activities. In theory a rise in the interest on bank loans could have been used to dampen the demand for them. In practice, however, this did not reduce the demand for credit, as state-owned enterprises lacked hard budget constraints and there was no stimulus to increase profits and lower the costs of production. In fact, in this system, there was no place for a traditional monetary policy; there was only room for a passive credit policy. Under such circumstances the central bank in the communist economy, i. e. in practice the largest bank, was not a bankers' bank (such as in market economies) but was merely an enterprises' bank.⁷

The financial system under consideration was not designed to perform the function of intermediation between surplus and deficit economic units, and, therefore, to transform savings into investment. As a result the financial system neither stimulated increases in the propensity to save nor did it influence the allocation of financial resources to investment projects. Under the bureaucratic co-ordination mechanism the level of investment was independent of economic units' voluntary savings, and the level (as well as the structure) of investment was decided by political bodies or the Central Planning Board without taking into account the financial aspects of the projects.⁸

The role assigned to monetary flows and the financial system in the command economy created certain peculiar properties non-existent in financial systems in fully developed market economies. First, the functioning and the structure of the financial system were not directed to stimulate the dynamics of economic development. In the

command economy it was assumed that this would be accomplished by selective processes imposed by government management based on real variables. Second, the financial system was essentially constructed to perform only an accommodative monetary (credit) policy, mainly because its primitive and highly formalized structure not only did not develop economic instruments to control the money supply but also led to lots of rigidities and, thus, to the absence of flexible channels of transmission for financial policy. This meant that the financial system was one of the important sources of excess demand in the communist economy, leading to a permanent state of shortages in the markets.⁹

The financial system outlined above existed virtually unchanged until the end of the 1980s in all East European countries (except Yugoslavia). It is true that throughout the decade some modifications were made in corporate finance and some countries like Hungary (1987) and Poland (1989) began to build a two-tier banking system. Nonetheless, despite these modifications the logic of the financial system did not essentially change.¹⁰

Inconsistency

The post-communist societies are now facing the task of moving away from the present economic system, which retains elements of the old bureaucratic mechanism, to a system based essentially on market co-ordination mechanisms. Money and financial institutions play a key role in regulating the functioning, and stimulating the growth of, market-oriented systems.¹¹ However, the financial system cannot be modified in the short run. The creation of a flexible and well-tuned financial system will require a long time. The emergence of a well-developed and efficient financial system is connected to the existence of a complex financial structure and an often highly complicated regulatory framework, which change in an evolutionary way. These changes, by nature, take a long time.

Nevertheless, virtually all East European countries are now trying to eliminate the remaining elements of bureaucratic co-ordination mechanisms. As the modifications of the financial system have to lag behind these attempts to pass to a market economy, post-communist societies are facing a basic problem: how to manage the economic system according to the logic of a market economy (i. e. with monetary and fiscal tools), while at the same time ensuring decent economic growth and the relative stability of the system? To what extent is it possible, under the existing institutional framework, to conduct market-type macroeconomic policies, securing simultaneously growth and stability?

It is well known that the financial system in a market economy performs both macro- and microeconomic

⁶ There were, however, major changes in investment financing. In the early stage of a communist economy investments were usually financed by budget subsidies. Later, bank credits acquired more importance in this respect.

⁷ T. M. Podolski: *Socialist Banking and Monetary Control: The Experience of Poland*, Cambridge University Press, Cambridge 1973.

⁸ Janos Kornai: *Economics of Shortage*, Amsterdam 1980; Andrzej Topiński: *Inflacja a funkcjonowanie gospodarki polskiej*, Warsaw 1989.

⁹ Janusz Beksiak and Urszula Libura: *Równowaga gospodarcza w socjalizmie*, Warsaw 1969.

¹⁰ For more detailed information on the financial systems in communist economies in the 1980s, cf. C. Kessides, T. King, M. Nuti and C. Sokil (eds.): *Financial Reform in Socialist Economies*, The World Bank, Washington D. C. 1989.

¹¹ Cf. Joseph A. Schumpeter, op.cit.; John G. Gurley and Edward S. Shaw, op.cit.

functions. At the macroeconomic level it enhances saving and mediates between the surplus units and deficit-spending units looking for sources of investment. Another macroeconomic function of the financial system is to provide a framework to supply the necessary quantity of money for smooth economic development. At the microeconomic level the role of the financial system is to secure the choice of the optimal allocation of money resources, i. e. that yielding the highest rate of return. The financial system in a market economy thus plays an active role in the selection processes. Finally, the financial system administers the payments between economic agents. The efficient performance of all these functions by the financial system leads to the reduction of the transaction costs of economic development and, therefore, increases the ability of the markets to develop.

A financial system whose structure and properties are directed to perform only passive accountancy and control functions is not able to conduct the tasks performed by the financial system in a market economy. Therefore, the financial systems inherited by post-communist societies are not suitable to harmonize efficiently the functioning of an economic system based on market co-ordination principles. In other words, there is a basic inconsistency between the institutional structure and the properties of the financial system on the one hand and the requirements of the new economic system on the other. This inconsistency already distorts current economic policy and will negatively influence the long-term economic development of post-communist countries.

More precisely, the principal spheres of the inconsistency between the anachronistic financial system and an economic system based on market co-ordination include the following major points. As mentioned above the inherited financial system does not stimulate the rise of savings, which is vital when there is a general lack of capital and a great demand for it caused by the need to restructure the real sphere of the economy during the transition process. Moreover, the allocative efficiency of the banking sector and capital markets does not develop overnight. Thus, even though the administrative mechanism for balancing investment with savings was abolished, it is doubtful whether the financial system can actively and smoothly transform savings into investment. Under these circumstances the economic development of

post-communist countries must have a propensity to low and uneven growth, and to strong inflationary or deflationary tendencies. The latter will also result from the absence of economic instruments which enable a relatively exact control of the money supply.

However, the highest degree of tension between the anachronistic financial system and the needs of a market economy must take place in the period in which the transition is made from one co-ordination mechanism to another. The departure from the bureaucratic mechanism, i. e. the increase in the decision-making autonomy of state-owned enterprises, combined with a passive financial system threatens a sharp destabilization of the economy, evidenced by the intensification of both open and suppressed inflation,¹² and in consequence by a decline in economic growth performance. On the other hand, under the anachronistic financial system the introduction of a highly restrictive economic policy to stabilize the economy by raising bank interest rates and introducing ceilings on extended credits inevitably leads to recession and only a limited success in combating inflation.

The Polish Experiences

At the threshold of the 1990s most formerly communist countries were in the first of the above-mentioned situations, as confirmed by their strong suppressed inflation and growth problems. Until now only a few post-communist countries have really begun the second phase on the road to a market economy. From this point of view the Polish case is uniquely interesting. First, in only two years (1989-1990) two conflicting economic policies were introduced to speed up the process of marketization. Second, the clash between the existing financial system, the adopted macroeconomic policy and economic development has been particularly visible in Poland.

Poland had already in 1982 attempted to abandon the traditional bureaucratic economic system in the direction of what J. Kornai called "reform socialism".¹³ One of the basic features of this economic reform was an absence of major changes in the financial system, although some modifications in corporate finance as well as in the price and tax systems took place.

In order to reduce the inflationary pressure efforts were made to conduct a tight monetary policy by placing ceilings on working-capital bank credits extended to state-owned enterprises. In the 1980s such a policy was introduced twice: from mid-1983 until mid-1985, and in 1987.¹⁴ This credit policy did not reduce inflation as enterprises always financed wages in the first instance and postponed the repayment of credits (and also taxes). More importantly, enterprises reacted to this restrictive credit policy by creating "chains of insolvency", an inter-firm trade credit

¹² Suppressed inflation is linked to the existence of administered prices, and thus the proportions between open and suppressed inflation may vary.

¹³ Cf. Janos Kornai: *The Affinity Between Ownership Forms ...*, op. cit.

¹⁴ Zbigniew Polański: *Dylematy polityki antyinflacyjnej u progu lat dziewięćdziesiątych*, in: *Bank i Kredyt*, 1989, No. 8-9, pp. 20-24.

Table 1
Development of the Banking System
in Poland, 1986 - 1990

	1986	1987	1988	1989	1990
Total Number	4	5	7	20	50
State Banks ¹	4	5	6	16	16
Non-Treasury Corporate Banks ²	—	—	1	4	33
Foreign Banks ³	—	—	—	—	1

¹ Including state-owned corporations.

² Banks in forms of corporations whose shares do not belong mainly to the State Treasury, and new private banks.

³ Corporations with more than 51% of foreign capital.

Notes: (1) The entries in the table show the number of operating banks at the end of the year. (2) The 1662 cooperative banks linked to the Agricultural Bank (BGZ), which were nominally independent units but in fact simply branches, are counted as 1 bank for the purpose of this table. It must be stressed, however, that in 1990 85 cooperative banks left the Agricultural Bank planning to begin independent activity. (3) At the end of 1990 there were 18 banks that had obtained a license to operate but were still under organization.

Source: National Bank of Poland.

Table 2
Gross National Income (GNI) in Poland,
1979 - 1990

(Constant prices, percentage change)¹

Year	GNI manufactured	GNI distributed	GNI distributed per capita
1979 - 1982 ^a	-5.4	-6.6	-7.4
1983 - 1987 ^a	4.3	4.2	3.4
1988	4.7	4.6	4.0
1989	0.1	0.3	0.0
1990	-13.4	-18.2	-18.5

¹ Material Product System.

^a Average.

Sources: Polish Central Statistical Office Yearbooks.

Table 3
Inflation in Poland, 1979 - 1989
(Percentage change)

Year	GNI distributed deflator	Food retail prices State shops	Private shops
1979 - 1981 ^a	10.6	11.0	29.0
1982 - 1987 ^a	32.1	32.6	23.1
1988	69.3	48.3	56.8
1989	294.4	337.7	278.6

^a Average.

Source: Polish Central Statistical Office Yearbooks.

which spilled over the whole socialized sector. The possibility of creating such credit on a wide scale was the result of the logic of the financial system. The assumption of the basic role of real flows in the economic process as well as the low level of working capital in state-owned enterprises induced – when attempts to decelerate the rise of credit supply became effective – the enterprises to operate on a trade credit basis. The possibility of the creation of such credit enabled the enterprises not to make any major adjustments in the field of efficiency. Thus, credit policy in the existing institutional framework was incapable of hampering inflation and speeding up the selective processes.

This policy of administrative restriction of bank credits also had a certain – although difficult to estimate exactly – negative impact on the volume of goods produced. Under the conditions of economics of shortage this fact enhanced the authorities to relax initially tight credit policies.

These negative results of the active use of credit policy to ensure macroeconomic stability as well as to expand the role of market mechanisms in the Polish economy were one of the factors that pushed the communist authorities to make changes in the financial structure of the economy. In the 1987-1989 period the National Bank of Poland was segmented, and a two-tier banking system was legally introduced.¹⁵ Also, already in the autumn of 1987, first issues of securities (by state-owned enterprises) were permitted. Nonetheless, despite these attempts to develop the financial sector it remained outdated and incapable of stimulating the development of market mechanisms and controlling rising inflation.¹⁶

The above problems with achieving economic stability and stimulating economic development were symptoms of the inconsistency described above. The rigid and rudimentary financial system distorted the macroeconomic policy, which neither stopped inflation nor enabled robust economic growth. As a consequence the last communist government, which took power in the autumn of 1988, started an economic policy which attempted to bypass the existing inconsistency between the financial system, restrictive credit policy and economic development. In order to stimulate economic growth and the growth of the private sector, both central planning and bureaucratic constraints on private activity were abolished. Simultaneously, control on credit-lending

¹⁵ On the quantitative development of the Polish banking sector cf. Table 1.

¹⁶ The links between the modifications in the monetary system, changes in economic policy and inflation in Poland in the 1980s are described in detail in: Zbigniew Polański: Inflation and the Monetary System in Poland in the 1980s, in: Osteuropa Wirtschaft, 1991.

activities was almost completely relaxed. Under the circumstances the withdrawal from the use of bureaucratic instruments to co-ordinate the economy led to a sharp rise in the inflation rate. The liberalization of food prices combined with a freeze of subsidies in the agricultural sector, in the circumstances of its monopolistic structure, led in August 1989 – in the absence of any monetary control – to hyperinflation.

The result of this attempt to bypass the outlined inconsistency proved to be unsuccessful not only because it led to a sharp rise in the inflation rate but also because recessionary tendencies appeared. In 1989 the volume of national income virtually stagnated.¹⁷

The 1990 Stabilization Effort

The collapse of the above policy, especially the development of hyperinflation, encouraged the adoption of a radically different policy. The new non-communist government, under the pressure of international financial institutions and in the absence of major alternative programmes by Polish economists, as well as in the face of great social expectations concerning a rapid reduction in the inflation rate, adopted an orthodox stabilization programme as a key element for economic policy in 1990.¹⁸

According to this programme all remaining elements of bureaucratic co-ordination should be abolished nearly at once, i. e. the programme assumed that the stabilization of the economy and its later development would take place practically without any direct state intervention. As one of the architects of the programme put it, "the revival will come by itself".¹⁹ Consequently, the programme focused mainly on non-selective macroeconomic policies. Monetary and fiscal measures, together with incomes policy (which was essentially a derivative of fiscal policy)²⁰ and rate of exchange policy were the main pillars of the programme for 1990. According to the Letter of Intent sent by Polish authorities to the International Monetary Fund in December 1989 it was expected that tight macroeconomic measures, coupled with liberalization, would cause the inflation rate to decline to 1% (on a monthly basis) in six

months and lead to the appearance of selective processes that would later induce economic growth. In general, the logic of the 1990 economic programme assumed that stabilization macropolicies should have priority while institutional changes ought to take place after stabilization was achieved. As a result the inconsistency between the existing institutional framework, economic policy and economic development presented itself in full scale.

In 1990 monetary policy, for the first time after the Second World War, became of primary importance in the Polish government's economic policy. The key characteristic of this monetary policy was its rigorousness. In face of the practical non-existence of financial markets,

Table 4
Inflation and Wages in the Socialized and Private Sectors in Poland, 1990

(Percentage change from previous month unless indicated otherwise)

Month	Consumer retail prices	Nominal wages	Real wages	Real wages ¹
January	79.6	1.8	-43.1	-43.3
February	23.8	15.4	-6.8	-47.2
March	4.3	40.1	34.3	-29.0
April	7.5	-8.8	-15.2	-39.8
May	4.6	-3.8	-8.0	-44.6
June	3.4	1.4	-1.9	-45.7
July	3.6	10.8	6.9	-41.9
August	1.8	4.8	2.9	-40.2
September	4.6	7.9	3.2	-38.3
October	5.7	13.6	7.5	-33.7
November	4.9	13.0	7.7	-28.6
December	5.9	9.6	3.5	-26.1
Dec. 1990 to Dec. 1989	249.3	158.1	-26.1	-

¹ Cumulative changes from December of previous year.

Source: Polish Central Statistical Office Yearbooks.

Table 5
Interest Rate on Refinancing Loans and the Rediscount Rate of the National Bank of Poland, 1990

Month	Interest rate	Rediscount rate
January	36.0	14.2
February	20.0	7.4
March	10.0	5.1
April	8.0	4.2
May	5.5	2.9
June	4.0	2.3
July - September	2.5	2.1
October	3.0	2.6
November - December	3.7	3.3

Note: Between January and June the interest rate was published on a monthly basis, while the rediscount rate was expressed on a quarterly one; since July both rates have been published on a yearly basis. All data in the table are shown on a monthly basis.

Source: National Bank of Poland.

¹⁷ Cf. Tables 2 and 3. It is necessary, however, to stress that some structural changes took place that year: while the volume of output in the socialized sector dropped by 2.6%, private sector output rose by 12%.

¹⁸ On the political and social circumstances leading to the adoption of this programme cf. Bartłomiej Kamiński: Systemic Underpinnings of the Transition in Poland: The Shadow of the Roundtable Agreement. Paper presented at the conference "Politics and Economics of the Transition", Tübingen, October 10-14, 1990.

¹⁹ Marek Dąbrowski: Trzeba jeszcze wytrwać, in: Polityka, May 26, 1990.

²⁰ The adoption of incomes policy was the only important non-orthodox measure in this programme.

only the interest rates on bank credits, reinforced additionally by credit ceilings, could be used to stop the growth of money supply. Thus a policy of a high (real positive) interest rate was adopted. It was gradually – on a monthly basis during the first half of the year – lowered in relation to changes in the inflation rate.²¹

Another important feature of the 1990 monetary policy was a nearly absolute withdrawal from selective credit policies, particularly in the first half of the year. As

Table 6
Reserve Requirement Ratios in Poland, 1989 - 1990
(in percent)

Type of Accounts	1989 1.03	1.03	1.04	1990 1.08	15.10	1.12
Transaction	15	9	15	27	30	30
Saving	10	9	15	17	20	30
Time	5	9	15	7	8	10

Source: National Bank of Poland.

Table 7
Socialized Industry Output (Constant prices)
and Money Supply (M2) in Poland, 1990

(Percentage change from previous month unless indicated otherwise)

Month	Output	Output ¹	M2	M2 ¹
January	-19.3	-19.3	41.5	41.5
February	-14.2	-30.7	21.6	72.1
March	10.5	-23.5	21.6	109.3
April	-8.5	-30.0	14.4	139.5
May	4.1	-27.1	11.6	167.3
June	-0.2	-27.3	13.7	204.0
July	-4.8	-30.8	14.2	247.0
August	7.7	-25.4	12.5	290.4
September	0.3	-25.2	7.4	319.2
October	11.7	-16.4	6.7	347.2
November	-3.4	-19.3	7.2	379.6
December	-5.8	-23.9	2.1	389.6
Dec. 1990 to Dec. 1989	-23.9	—	389.6	—

Note: M2 foreign currency deposits excluded.

¹ Cumulative changes from December 1989.

Sources: Polish Central Statistical Office and National Bank of Poland.

Table 8
Unemployment in Poland, 1990
(in percent)

Month	Percentage of total workforce	Percentage of total workforce, agriculture excluded
January	0.3	0.4
March	1.5	2.0
July	3.8	5.2
December	6.1	8.3

Source: Polish Central Statistical Office.

mentioned, this was an element of a wider economic strategy: tax exemptions were also abolished and subsidies were cut further.

Moral Suasion

However, despite the introduction at the beginning of 1990 of a package of systemic changes in the economy's mechanisms, monetary policy essentially continued to be a credit policy. Although formally the monobank no longer existed, in practice the main tool of the central bank to control credit expansion continued to be the interest rates on loans extended by (in theory) independent commercial banks. This was achieved through "moral suasion". Its use was facilitated by the fact that the largest Polish commercial banks were created by the partition of the National Bank of Poland (and remained state-owned).

Attempts were also made to utilize instruments more typical for central bank management in market economies. However, in the absence of developed financial markets, only one instrument could be used more actively, namely changes in the reserve requirement ratios. In order to decrease the banks' excessive liquidity these ratios were changed several times during 1990.²²

Both ways of controlling the money supply, moral suasion and the increase of reserve requirement ratios, had a negative impact on the performance of the financial system by inducing additional uncertainty and hampering the development of financial markets. Moreover, they proved to be largely ineffective: by mid-1990 the rise in the increase of the money supply (M2) was already higher than that planned for the whole year, thus allowing prices to rise much more than intended.²³ However, this rise in the money supply was not only the result of the credit expansion but was mainly linked to the high trade surplus, which the government had not expected.²⁴

Nonetheless, the 1990 monetary policy was an important attempt to withdraw from the automatic and very selective credit policies of previous governments in the absence of a suitable economic and institutional framework. How then did the economy react to such a policy?

²¹ Cf. Tables 4 and 5.

²² Cf. Table 6.

²³ The dynamics of the rise of the money supply during 1990 is shown in Table 7.

²⁴ Other instruments of monetary control used by the Polish central bank were the interest rate on refinancing loans and the rediscount rate on bills of exchange. Their evolution is shown in Table 6. Neither of these played a major effective role in controlling the money supply because of the banks' excess liquidity (due to the above-mentioned trade surplus), and enterprises' reluctance to use bills of exchange. Also, the remaining monetary instruments were of very minor importance or of none at all as in the case of attempts to conduct money market operations or the lombard credit mechanism respectively.

Economy's Reaction

First of all, essential changes in the markets took place. Thanks to price liberalization and the control of credit supply the so-called seller's market, a typical feature of the communist economy, was eliminated, and shortages of goods were substantially reduced, i. e. the condition of permanent suppressed inflation was abolished. Simultaneously, a buyer's market gradually evolved. As a result virtually all enterprises have faced a demand constraint for the first time in their existence.

The socialized sector, which in 1989 still produced 80.8% of the national income, reduced its demand for bank credit by three forms of behaviour adjustment. First, state-owned enterprises reduced their level of output: in 1990, the volume of output produced by socialized industry was 25% lower than in 1989. Second, state-owned enterprises reduced the demand for working capital credit from banks by increasing claims against themselves, i. e. by creating, as in the previous decade, trade credit. This credit compensated the difficulties arising from high interest rates on credits offered by banks, from the use of credit ceilings and from problems with selling manufactured goods. During the entire first half of 1990 the value of dues resulting from deliveries was above 52% of the enterprises' current assets. A third way of diminishing the need for working capital credits were the attempts to issue securities by enterprises, particularly the bills of exchange. At the end of 1989 the National Bank of Poland committed itself to rediscount these bills, assuming that in this way it would control the substitution of trade credit for bank credit, and thus would be capable of more precise management of the money supply. Until now, however, bills of exchange have not gained greatly in popularity. They still have not become a basic instrument in the enterprises' payments mechanism. This is due mainly to the fact that their issue is linked to civil responsibility and the easiness to use trade credit outside the control of the banking system. Other types of securities, which could be used to finance the activities of enterprises in 1990, also have not played a major role. This was a direct result of the non-existence of financial markets.

Paradoxical Situation

A paradoxical situation has emerged as a result of all these processes. The socialized sector has gone into a deep recession and has generated rising unemployment,²⁵ while at the same time the average financial situation of the enterprises comprising it improved and bankruptcies were virtually non-existent. This improvement in the financial situation was due mainly to much higher price rises than expected, which in turn were the result of the monopolistic power of state-owned

enterprises and the problems with the control of the money supply. Thus, despite very tight credit (and fiscal) policies as well as nearly absolute domestic economic liberalization, selection mechanisms have not appeared and the structure of this basic sector of the Polish economy has practically not yet begun to change.

As the private sector is not monopolized, and it does not create "chains of insolvency" as the socialized sector does, the policy of strict credit control forced different types of adjustment attitudes, particularly in the private sector beyond agriculture. In the first quarter of 1990 more small businesses were closed down or temporarily ceased functioning than new entities were created. Nonetheless, in subsequent months the small business sector began to expand, mainly in trade and service activities.

Bankruptcies have not taken place in the private farming sector. However, as in the remaining sectors, farmers also tried to reduce output, as evidenced by their lower demand for agricultural means of production, which was to a great extent a result of the policy of high interest rates.²⁶ Thus, the processes of selection and restructuring, which were expected to be the result of the full liberalization of the economy and tight economic policy, have taken place only in part of the private sector.

While interpreting the above phenomena from the point of view of the financial system, it is necessary to point out that the distorted results of the monetary policy were intensified by a quick and nearly absolute cut in budget subsidies. It is understandable that this had to be done to restore a correct system of relative prices and to hamper hyperinflation. On the other hand, due to the rigidities of the financial system and its great simplicity, the sudden withdrawal from wide budget subsidies combined with a non-selective tight credit policy led to huge negative side-effects, e. g. in the field of housing where prices jumped and long-term recessionary tendencies substantially deepened.

Policy Evolution

As a consequence of a much larger drop in output, more rapidly increasing unemployment and a stronger persistence of inflation than expected, macroeconomic policy has undergone a certain gradual evolution. Already in mid-March 1990 some selectivity concerning agricultural credit policy was restored. In the second half of the year a policy of preferential credit was widened to other parts of the private sector, mainly newly created private

²⁵ For more information on these processes see Tables 7 and 8.

²⁶ Another important factor which influenced the decline of farming demand for means of production was the inconvenient relation between their prices and the prices of agricultural output.

businesses. Since mid-1990, a yearly based interest rate on bank credits was restored. Not only did credit policy become less tight but also budget expenses increased and incomes policy was loosened. Attempts were also made to prepare more coherent policy packages concerning two sectors of the economy: housing and farming. The work on privatization was also somewhat accelerated.

As a result of these changes, especially in credit and incomes policy, the new private sector began to develop quicker, the farming sector managed to harvest its crop without major problems and real wages in the socialized sector stopped going down. Nevertheless, recession in the latter sector has not ended. Simultaneously, since the end of August, inflationary pressure has re-intensified.

This rise in inflation encouraged a new tightening of monetary policy: in October and November interest rates and reserve requirement ratios were once again increased. There was concern, confirmed by the 1991 economic processes, that these changes would not help in the recovery of the Polish economy. These dilemmas, however, confirm the existence of the inconsistency between the financial system, economic policy and development by the fact that under the existing institutional circumstances non-inflationary economic growth is not possible.

The Lessons

The 1990 experience in Poland has been a complete collision between the need for rapid stabilization and the present anachronistic financial system. The adoption of an orthodox programme, implying a perfect spillover of monetary flows throughout the economy and the full responsiveness of economic agents to monetary and fiscal policy variables, led to highly distorted effects. Macroeconomic policies aimed at financial discipline applied to a rigid financial system induced a major recession, which did not stimulate greater changes in the structure of the economy, without definitely hampering inflation.

The Polish 1990 experiences support research stressing that neoclassical economics cannot properly underpin reforms in post-communist economies.²⁷ If there is no hyperinflation, then, orthodox (i. e. essentially based on neoclassical assumptions) programmes should not be the leading element of economic policy in the transition process.

The main lesson from the Polish 1990 experience is that countries which embark on the transition process (and which do not have hyperinflationary pressures) should in the first instance pay more attention to institutional changes and adopt more selective macropolicies. The former means that the development of the market

economy infrastructure should be accelerated, especially the development of the financial system. The abolition of selective credit and fiscal policies in the situation of a primitive financial system, i. e. with the existing rigidities and the non-existence of smooth transmission mechanisms, hampers the structural changes by reducing the scale of selective processes.

However, the development of the market economy infrastructure cannot be accelerated beyond a certain point. This is due to the fact that the creation of a new institutional framework is strictly linked – among other things – to the privatization of the economy, the demonopolization of the socialized sector, and the learning process of the economic agents. A new institutional framework not only means a new legal framework and a change in the quantity of institutions (e. g. in the number of banks). A new institutional framework also, if not mainly, means a rise in the quality of services performed by the economic institutions, i. e. a change in the behaviour of these institutions.

While economic policy can be diametrically changed overnight, institutional development by its nature has a gradual, evolving character. As a consequence of this, the principles of current economic policy should be linked to these gradual modifications. In order to minimize the costs of transition from a bureaucratic coordination mechanism to a market one, the construction of economic policy has to be strictly linked to the progress made in the institutional development of the economy.

The current economic discussion on the future of post-communist societies shows a complete rejection of the concept of the so-called "Third Way". In light of the experiences of the last twenty years, this concept of a blend of the best features of market and communist economies is another utopian system which belongs to the history of economic thought. However, the concept of a third way understood as a way to move to a market economy from a command economy is still well-founded. Post-communist countries neither can rely on the market experiments performed by some former communist governments, which led to great destabilization, nor should they – as the Polish case shows – rely on orthodox programmes based on neoclassical paradigms. Because of the existing social and economic differences among post-communist countries, their governments have to work out their own visions of how to reach the market system. In this sense the concept of a third way (more exactly speaking: of several third ways) continues to be present.

²⁷ Peter Murell: Can Neoclassical Economics Underpin the Economic Reform of the Centrally-Planned Economies?, in: *Journal of Economic Perspectives*, 1991.