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Contents

THE FINANCIAL SYSTEM IN POLAND AND TRENDS OF ITS DEVELOPMENT

Marek Dąbrowski

1. Introduction

Poland was the first post-communist country that began the transition to a market economy. It began at the end of 1989, when Poland's first democratic government under Tadeusz Mazowiecki announced its comprehensive and radical economic program aimed at fighting near-hyperinflation and transforming the socialist economic system into a capitalist one. Having experienced the smallest output decline among post-communist countries and being the first to have economic growth at quite an impressive rate, Poland has become a symbol of transition success. International financial institutions and many world-known experts often refer to the Polish experience as a positive example for other post-communist countries.

Looking back over the seven years of transition in Poland, it is necessary, however, to notice that the pace of economic change was uneven. While the first two years (1990-1991) can be characterized as a period of very fast and comprehensive reforms, this gradually slowed down in later years as political will and energy declined. This has been particularly true over the last three years, when the ruling left coalition concentrated on consuming the positive effects of reforms undertaken in the beginning of the decade rather than on completing their unfinished agenda.

The topic of this study relates to a component of the transition process, namely macroeconomic policy, and is mainly oriented towards the next decade (till 2005). At the end of 1996, the Polish economy continues to experience fast economic growth and inflation is continuing its downward trend. In terms of inflation however, the 18% expected inflation for 1996 (December to Dec.) puts Poland behind many other transition economies and this cannot be seen as satisfactory. There are other problems which may create serious troubles in the medium and long run. These include the slow pace of remonetization, the inability to stabilize the exchange rate, high budget expenditure and revenue ratio to GDP, the high level of public debt, and the high share of social spending, especially pensions in the budget.

Thus, this paper has a rather normative than descriptive character and presents an *ex ante* rather than *ex post* analysis. Its main purpose is to propose a medium and long-term concept of macroeconomic policy that would be able to support the process of smooth integration of Poland into the European Union in the next decade. The main goals of this program are to combine more energetic disinflation with the creation of a solid macroeconomic foundation needed for long-term and sustainable economic growth.

The structure of the report is as follows: Section 2 contains a synthetic diagnosis of Poland's macroeconomic situation at the end of 1996 after seven years of transition, in comparison with other post-communist countries. Section 3 presents four variants of political and macroeconomic scenarios for the next decade, when Poland is expected to enter the European Union. Section 4 discusses the question of how to accelerate the pace of disinflation. Section 5 is devoted to the problems of fiscal policy and section 6 tries to address the issue of income policy and its potential role in the disinflation process. In section 7, I will discuss the basic institutional frameworks which can help make macroeconomic policy more stable and less discretionary. In the first instance, it relates to the question of central bank independence and constitutional framework for the fiscal process. Finally, in section 8, I summarize the basic conclusions and recommendations made from the previous sections.

The author's opinions and proposals presented in this paper, are heavily based on the results of the research project *"The Second Stage of Economic and Political Transition"* being carried out by the Center for Social and Economic Research (CASE) in Warsaw from October 1995 to January 1997 and

financed by the United States Agency for International Development. The macroeconomic policy questions were extensively explored and discussed by one of seven research groups working under this project. The presented paper has a very synthetic character and only summarizes the main findings and conclusions of this collective work.

Author is particularly obliged to the contribution provided by Witold Orłowski and Adam Bartłomiej Czyżewski (used in section 3), Stanisław Gomułka (used in section 5), Lucjan T. Orłowski (used in section 4), Andrzej Wojtyna, Paweł Dobrowolski and Wojciech Kostrzewa (section 7). Przemysław Woźniak and Ryszard Petru were responsible for preparing the statistical appendix (tables and graphs). Also the written and oral contribution (in the form of background papers or seminar presentations) of Jarosław Bauc, Marek Belka, Andrzej S. Bratkowski, Anna Czarczyńska, Hanna Gronkiewicz-Waltz, Krzysztof Kalicki, Urszula Kosterna, Witold Koziński, Katarzyna Śledziewska-Kołodziejska, Stanisław Wellisz, and Leszek Zienkowski were taken into consideration. Organizational support of Katarzyna Piętka, Kamila Kloc, Elena Kozarzewska, Małgorzata Antczak and Ryszard Petru on different stages of this project was of crucial importance for its carrying out. Finally, Emmanuel Oudsis was in charge of English language editing of this paper. However, only the author takes the full responsibility for the final content and quality of this report, and for the presented opinions and conclusions. These opinions and conclusions do not necessarily reflect the positions of the above mentioned individual contributors, the CASE, and the sponsoring agency.

2. Poland's macroeconomic situation at the end of 1996: Fast growth and slow disinflation

The macroeconomic results of seven years of Polish transition is uneven. On the one hand, Poland has accomplished the best cumulative GDP record of transition countries (see Table 1). The decline in GDP lasted only two years (1990-91) and its cumulative effect did not exceed 20%, according to official statistics[1]. Since 1992, or more specifically since the last quarter of 1991, Poland has experienced output recovery at a steadily increased rate.

On the other hand, in spite of being the first post-communist country to implement a stabilization program (on 1 January, 1990[2]), Poland is obviously not a leader in the disinflation process. Although the annual rate of inflation is decreasing every year (see Graph 1), the expected end of year rate of inflation for 1996 of some 18% is still a quite high and puts Poland behind many other transition countries in this respect (see — Tables 2 and 3). According to EBRD data (Stern, 1996) and Table 3, in 1995, Poland, with an end of year rate of inflation of 21.8%, was outpaced by 6 other countries: Croatia, Albania, Slovakia, Slovenia, the Czech Republic, and Macedonia. In 1996, despite the continuing downward trend of inflation, Poland will probably fall behind Moldova, Estonia, Latvia, and Georgia.

If we take into consideration the rate of disinflation, it looks quite favorable compared to the two other Central European countries, the Czech Republic and Hungary[3] (see — Graph 2) but far less favorable compared to many FSU and FY countries such as Estonia, Latvia, Moldova, Lithuania, Georgia, Kazakhstan, Armenia, Slovenia, Croatia, and Macedonia (see — Graphs 3, 3a, and 3b).

If we look at monthly price statistics in Poland, (Graph 4) we find large fluctuations in the inflation rate. This cannot be solely explained by the seasonal price fluctuation of the food market common to most transition economies. Rather, it seems to reflects large changes in the money supply and in the demand for money (see — below).

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[1] Similarly to other post-communist countries official statistics overestimate the transition output decline. The detail discussion of this question is going far beyond the topic and limited size of this paper. Shortly speaking, in the case of Poland initial GDP level (in 1988 and 1989) was overestimated (mainly due to problems connected with GDP deflators under very high inflation and recording inventories) and underestimated for the transition years. For more extensive discussion of this issue in relation to the Polish economy — see Bratkowski [1993].

[2] Few weeks earlier former Yugoslavia also started strong anti-inflationary program which initially succeeded. Unfortunately, due to the political disintegration of the Yugoslav federation started in fact already in 1990 the positive effect of this program was very short living.

[3] It relates particularly to Hungary which, starting from moderate level of inflation in 1990 (33.4%) and going down rather slowly, reversed the trend in 1995 when inflation jumped to 28%.

Exchange rate developments additionally confirm the weakness of the anti-inflationary effort in Poland. Table 4 and Graph 5 show that since May 1991 (i.e., after 16 months of a fixed exchange rate) the zloty has been subject to continuous nominal depreciation — apart from the two occasional revaluations in May and December 1995. One can talk about two-side dependence. On the one hand, devaluation has been unavoidable as result of relatively high inflation (to avoid too much real appreciation, loss of competitiveness and a balance of payments crisis). On the other hand, continuous devaluation (particularly a preannounced crawling peg formula) has additionally fueled inflationary inertia, through price mechanism and inflationary expectations.

Graph 6 illustrates the real appreciation of zloty, particularly in 1995. Indirectly, this supports the hypothesis that the exchange rate could be used more actively as a tool of the anti-inflationary policy. The same impression appears from comparing exchange rate developments in Poland and in other transition economies (see — Table 5). The experiences of the Czech Republic (no devaluation since 1991), Slovakia (only one small devaluation in mid-1993), Estonia (currency board and a stable exchange rate in relation to the DM since June 1992), Latvia (appreciating or stable exchange rate in relation to the SDR), and Lithuania (currency board and stable exchange rate in relation to the US dollar since April 1994) is evidence that the permanent devaluation of a national currency can be avoided and this helps price stability. The countries mentioned above have either lower inflation than Poland (Czech Republic, Slovakia), or, presently, a faster disinflation trend than in Poland (Baltic countries).

Attempts to identify the sources of continuous inflationary pressure in Poland must start from the standard analysis of money supply and demand for money. Table 6 shows that the policy of money supply was generally quite expansive. Graphs 7a & 7b confirm that we can observe some general causal dependence between money supply and inflation rate, with, however, a lot of short term variability. This leads us to the question of the demand for money which, when we take into account the aggregate annual figures (see Table 7), has remained relatively stable and low throughout the post-stabilization period (after 1990). However, an indirect examination of monthly data (see Graphs 7a & 7b) suggests that short term demand for money in Poland is very unstable[4].

If we compare the velocity of domestic money in Poland to other transition economies (see Table 8 and Graph 8), we find that monetization of the Polish economy is much lower than in Czech and Slovak Republics. However, Poland has a monetization level similar to Slovakia, Hungary[5], Estonia, and Latvia. The difference between the Czech Republic and Slovakia on the one hand, and Poland, other Central European and Baltic countries on the other hand, can be partly explained by the lack of high inflation/hyperinflation history in the former group. According to Wellisz (1995), the level of total monetization of the Polish economy (including foreign exchange deposits) is generally in line with the level of GDP per capita. This would mean that demand for money in the Polish economy does not differ from demand in economies representing a similar level of economic development.

Not questioning this general point, it is necessary, however, to mention two problems. First, after initial moderate monetization, which took place in the second half of 1990 and 1991 (just after the completion of the first stage of the stabilization program), total broad money velocity (including foreign exchange deposits) presented a stable level (see Table 7). This means that despite fast economic growth and dynamic development of financial market institutions in 1993-1995, the demand for money per GDP unit has not grown. The domestic broad money velocity even increased in 1993 and 1994 (compared to 1992) and only went down in 1995. Second, the share of the foreign exchange deposits in the total money supply in Poland (dollarization ratio) is still substantial and is going down very slowly. This is directly evident from Table 9 and indirectly from Graph 9.

It seems that the limited progress in rebuilding demand for money is a result of the combination of three main factors (Dąbrowski, 1995):

– exchange rate policy, i.e., continuation of a preannounced crawling peg devaluation;

– interest rate policy, i.e., prevailing negative real interest rate for deposits (see Table 10 and Graphs 10a and 10b);

[4] The direct examination of monthly money velocity changes is impossible because of the lack of monthly GDP statistics.

[5] In the beginning of transition Hungary represented higher monetization level than Poland. However, in 1993-1995 it came down in Hungary and now it does not differ from the Polish one.

– low credibility of monetary and, more general, all macroeconomic policy, due to regular failures in inflation forecasting, bad cooperation between the Ministry of Finance and National Bank of Poland, a lack of sufficient legal and actual independence of the NBP (see section 7), etc.

Several authors (see Orlowski, 1994; Raport, 1996) stress the importance of other, so-called non-monetary factors such as wage indexation, continuous administrative price adjustment, protectionist tendencies in trade policy (particularly in relation to the agricultural market), etc. Not questioning the partial explanatory power of these hypotheses, it seems that they did not play a primary role in maintaining the moderately high money velocity in the analyzed period, particularly in 1995-1996.

Analyzing the sources of reserve money growth, one can observe large variability during the analyzed period. In 1990, the dominant factors were the growth of international reserves and credit to commercial banks. From 1991 to 1994, most of money base growth came from net NBP credit to government, i.e., from monetizing the fiscal deficit. In 1995 and 1996, the biggest pressure came again from the balance of payments, partly neutralized by a very intensive sterilization[6].

The above brief overview of sources of monetary expansion stresses the role fiscal imbalances. Table 11 shows that, apart from 1990, the general government balance was negative throughout the transition period (particularly in 1989, 1991 and 1992). According to the periodization proposed by Dąbrowski (1996), the large budget deficit in 1989 can be related to the initial (pre-transition) fiscal crisis and the 1991-1992 period represents the secondary (post-stabilization) fiscal crisis. Since 1993, the general government balance has improved as result of output recovery, the completion of comprehensive tax reform, and limited adjustments to the expenditure side (Dąbrowski, 1996). However, the adjustment process was stopped in 1995 and even slightly reversed, despite fast GDP growth and improved tax collection. The expected budget execution in 1996 and the 1997 draft budget represent a continuation of this unfavorable trend though at very modest rate. It stays in conflict with the ambitious macroeconomic targets announced in the official government document "Strategy for Poland" and "Package 2000."

Table 11 also shows that the consolidated fiscal deficit was, in practice, totally financed from domestic sources. More precisely, the scale of domestic deficit financing was usually higher than the size of deficit itself due to the negative balance of external financing[7]. Up to 1994, the NBP directly absorbed a significant part of this financing. As for the 1991-1992 period, direct NBP involvement in deficit financing was probably unavoidable because of the large size of the deficit and the limited capacity of the domestic treasury bills market. The continuation of this practice in the two years that followed, must be seen as evidence of the weak political position of the central bank in relation to the parliament and government.

Mainly as result of the debt reduction decisions taken by the Paris and London Clubs, total public debt and, in particular, total external debt are on a strong downward trend (see Table 11). Real appreciation of zloty in 1995 and 1996 also contributed to this trend. Both factors also influenced the change of composition of the total public debt in favor of its domestic component.

The current size of its fiscal deficit puts Poland in the middle rank of Central and Eastern European countries (see Table 12). In this respect, Poland is doing better than Bulgaria, Romania, Albania, Hungary and most of the FSU countries but worse than Estonia, Czech Republic, Slovenia, Slovakia or Croatia.

The continuous budget deficit, despite very high GDP growth rate and improving tax collection, is not the only fiscal problem experienced by Poland. Like in other Central European countries, the size of government in Poland is excessive and threatens the long term fundamentals of economic growth (Dąbrowski and Kostema, 1996). This particularly relates to social expenditures where pension benefits play an absolutely dominant role (see Golinowska, 1996).

3. Macroeconomic scenarios for the next decade

Based on projections prepared by Czyżewski and Orłowski (1996), one can distinguish four possible macroeconomic scenarios for the decade 1996-2005, each very dependent on different scenarios of political developments:

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[6] Continuos devaluation did not help in controlling this factor of monetary expansion.

[7] The balance of negative external financing was particularly high (almost 2% of GDP) in 1994 as result of buy-back operation connected with the London Club debt reduction agreement.

1) scenario of stopped reforms,
2) scenario of modest reforms,
3) scenario of convergence,
4) scenario of convergence and growth.

(Table 13 presents assumptions of the projections and Table 14 its basic results.)

All four scenarios assume that Poland will become a member of the European Union in the years 2001-2002. For all scenarios, there are common assumptions concerning foreign debt service, the rate of economic growth in the EU countries, labor supply, number of pensioners, real interest rates, LIBOR, tariffs levels and levels of official reserves. What differs in the four scenarios is the scale and depth of reform of the public sector, particularly of the pension system and of basic public services such as health care and education. These influence the size of public expenditure in relation to GDP, the fiscal balance, the size of public debt, the inflation rate, and consequently the size of future transfers from the EU budget and private capital inflow. Finally, the different stocks of total saving (domestic and foreign) available for investment financing determine the different rates of GDP growth.

Table 14 shows that only scenarios 3 and 4 guarantee the continuation of the high rate of economic growth and compliance with the Maastricht convergence criteria. Under scenarios 1 and 2, the initial high rate of growth will decrease to below 4% in 2005. Scenario 1 does not give any chance of meeting the Maastricht criteria and under scenario 2 only partial compliance is possible.

The projections persuasively show that from a long & medium-term perspective, a more radical disinflation target converges with fast economic growth. Only in the short term will a more restrictive monetary policy involve some sacrifice in the form of a little bit slower GDP growth overcompensated in the perspective of all decade.

It is clear that different scenarios will mean various models (and probably formal statuses) of EU membership. While scenarios 3 and 4 make full EU membership (include. European Monetary Union) in 2005 possible, the first two scenarios, particularly scenario 1, must be interpreted, at best, as the road to second category membership.

4. Disinflation, monetary, and exchange rate policy

As we have seen in the previous section, progress in bringing down the inflation rate in the coming years will be of key importance for the long term growth perspective and status of Poland's membership into the EU. In interpreting inflation as a predominantly monetary phenomenon, particular attention must be paid to monetary policy instruments. During last few years, this policy has lacked real anchors. The NBP has tried to simultaneously control several policy targets (quantity monetary aggregates, exchange rate, and interest rate) which has, in practice, given a lot of inconsequence and inconsistency in actual policy.

In theory, one can discuss two possible "pure" models of monetary policy aimed at accelerating the disinflation process:

– targeting the broad money and money base aggregate while making the exchange rate freely floating (i.e., stabilizing the amount of the net international reserves of the central bank);

– targeting the stable exchange rate (in the extreme case of a currency board or quasi currency board, this means stabilization of the net domestic assets of the central bank).

Both variants present advantages and disadvantages. In the first variant, monetary target(s) are technically easier to control by the central bank and this gives the central bank more discretion. Theoretically, it makes domestic monetary policy less dependent on external monetary and trade shocks — under the condition, however, that the central bank is able to reject pressure to intervene on the foreign exchange market. The second variant is more transparent to the broader public and helps eliminate exchange rate fluctuations and exchange rate risk. On the other hand, this variant is connected with the danger of exchange rate overvaluation in the case where the country is subject to a negative external shock or if other macroeconomic fundamentals (especially in the sphere of fiscal and income policies) are out of line.

In the case of Poland, the second concept (i.e., stabilizing the exchange rate in the narrow band) seems to be more suitable for the following reasons:

First, it would help fight the inflationary inertia, particularly in the situation where the hitherto announced crawling peg (band) can be seen as the main factor of this inertia.

Second, it can stimulate demand for domestic money by eliminating devaluation uncertainty and bringing down inflationary expectations.

Third, the stable exchange rate allows, all other things being equal, lower nominal interest rates and a less restrictive money supply.

Fourth, the relative underdevelopment of financial markets in Poland (in comparison with developed countries) makes free floating exchange rates dangerous for the financial stability of the banking sector (excessive exchange rate risk) as well as for the stability of the treasury bills market and other segments of financial markets. It also makes the economic calculations of export industries more uncertain than under a stable exchange rate regime.

Fifth, large expected capital inflow in the coming decade (as a consequence of accession to the OECD and EU — see section 3) decrease the danger of a balance of payments crisis (historical data on balance of payment is shown in Table 15).

Sixth, such a solutions helps Poland for future participation in the ERM (and EMU).

Because, in practice, none of the above variants can be applied in their pure form, the presented proposal does not eliminate the necessity of the NBP to monitor the broad domestic money aggregate and react in the case of big external shocks (capital inflows) by implementing a sterilization policy (or reserve requirements ratio). A stable exchange rate must also be supported by sound fiscal policy and more flexible wage setting. These problems will be discussed in the next two sections.

5. Fiscal policy

Fiscal policy in the coming decade should be oriented towards following targets:

– Elimination of the budget deficit. This will help eliminate inflationary pressures coming from fiscal policy[8]. This will also stop the increase in public debt and the absorption of private savings for private and collective consumption.

– Downsizing the public sector, i.e., the share of general government expenditure and revenue in GDP. This will create room for decreasing tax rates without threatening the fiscal balance. It will also contribute to increasing the rate of private savings.

– Minimizing allocative distortions coming from the different forms of fiscal redistribution. This relates primarily to the differentiation of tax rates and tax exemptions and to different types of explicit and implicit subsidies.

Any kind of deeper fiscal adjustment must involve the issue of pension reform. According to Gomułka (1996b) total pension expenditure in 1996 will amount to 15.6% of GDP. This is due to the high replacement rate[9] and the large, still increasing, number of pensioners (at an annual rate of 1.5% according to Gomułka (1996b)).

In discussing the direction of pension reform, two of stages should be taken into consideration. The first stage would be connected with cuts in the existing PAYG system with the purpose of stopping expansion or even decreasing the share of current pension expenditure in GDP. This set of measures should not only help in fiscal adjustment but also create macroeconomic room for the second stage (or second and third tier of the pension system).

The list of measures that would contribute to the "cleaning up" of the existing PAYG system is a long one, and includes, increasing the retirement age of women (gradually to the age of 65), eliminating several branch and professional pension privileges, and tightening the entitlement criteria for disability pensions. According to Gomułka (1996b), all these measures should stabilize the number of pensioners at the current level of 9.55 millions people, neutralizing the negative demographic trend. Additionally, the change in indexation formula should lead to the gradual decrease of the replacement rate and, consequently, to decreasing pension expenditures relative to GDP.

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[8] In fact we have two side dependence. Lower inflation helps to decrease current interest payments for public debt denominated in domestic currency [see Gomułka, 1996a].

[9] According to WEO [1996, table 22] the ratio of average old-age pension to average wage amounted in 1992 to 86.3% and was the highest among transition countries. According to Golinowska [1996] the ratio of net average pension to net average wage amounted in 1994 to 74.8% (higher only in Slovenia) and presented rising trend.

Gomułka (1996b) discusses two possible variants of pension indexation reform (in comparison with the rules that exist in 1996 and that are proposed for 1997 which guarantee a real increase in pension by 2% per year):

a) adoption of a pure price indexation formula which would mean stabilization of the real level of pensions at the current level; this variant would result in expenditure cuts of 0.53% of GDP in 1997 and subsequent increases in later years as the replacement rate gradually decreases;

b) adoption of the mixed price-wage indexation formula, giving an annual real increase of pensions of 1%; this variant would result in expenditure cuts of 0.38% of GDP in 1997 and subsequent increases in later years.

The second and more fundamental stage of pension reform should be a partial transition from the PAYG system to a fully funded private system. Such reform must be connected with a significant fiscal burden, resulting mainly from disclosing unfunded pension liabilities existing under the PAYG system. (Those employed who will start to build their individual pension accounts under the fully funded system will stop, at least partly, their contribution to the PAYG system). The size of transition costs will depend on the speed of transition — here is the main possibility of the fiscal monitoring of this process. The detailed calculations of the fiscal implications of this type of pension reform is beyond the scope of this paper. Here, we may only generally stress three potential sources of financing:

a) Revenues from privatization or privatization assets of good quality.

b) Part of the financial gains coming from the first stage of pension reform (see above) or from further cuts in the PAYG system.

c) Increasing the public debt through securatization of the unfunded part of pension liabilities.

Pension reform is not the expenditure cut that can be made in the next few years. Generally one can mention the following list of potential expenditure reductions:

– remaining subsidies (for example, for central heating and hot water), different kind of restructuring programs, credit guarantees, etc.;

– agriculture interventionism (among others, subsidized credits);

– social programs other than pension system (unemployment benefits, ALMP programs, housing social assistance, family benefits, Disability Fund);

– so-called budgetary sphere (mainly overemployment in some sectors);

– public investment programs.

Even without deeper institutional reforms (for example in the sphere of health care and education), it seems possible to find some simple expenditure cuts amounting to at least 1% of GDP. A more aggressive disinflation path would also make it possible to reduce the cost of servicing the public debt (see Gomułka, 1996a). All the above measures taken together would eliminate the budget deficit completely or, at least, reduce it to a level less than 1% of GDP. This would further influence the reduction of the interest payment item.

After eliminating the budget deficit (or downsizing it significantly), tax reduction should be the next target of fiscal policy adjustment. Two measures in this area should be seen as priorities:

– decreasing the personal income tax rates from the current 21, 33 and 45%, and 20, 32, and 44% in 1997 to 20, 30 and 40% (i.e., returning to the 1992 tax scale);

– decreasing the corporate income tax rates from the current 40% and 38% in 1997 to 32% or 30%.

The total cost of such an operation should not exceed 1% of GDP compared to the 1997 tax system and budget draft. At the same time, part of this reduction could be financed by further reductions of tax exemptions in income taxes as well as by broadening the basic VAT rate of 22%.

The tax system, particularly the system of indirect taxation and custom duties, will have to adjust over the next five years to EU standards. The same concerns the system of budget planning and execution.

6. Income policy

At the beginning of the 90s, income policy, and particularly the excessive wage tax "*popiwek*," was a subject of strong theoretical and political disputes. A gradual elimination of this tax in 1994, preceded by its significant softening in 1992-1993, means that, in practice, there are no active income policy instruments. Wage recommendations set each year by the trilateral commission (represented by employees, employers, and government) do not have an obligatory character and are usually not respected at the enterprise level.

The trilateral commission plays a bigger role in negotiations regarding wage policy in the budgetary sphere. In 1995, this replaced the previous formal parity indexation according to the law from January 1989 which was never fully implemented because of its fiscal unreality.

While some regulating role by the trilateral commission with respect to wages in the budgetary sphere seems to be justified, attempts to extend this mission in this sphere seems to be problematic. In practice, it would only lead to increasing wage pressures at the macro level, strengthen the indexation practices in wage setting and hence the inflationary inertia, and make labor markets more rigid which would probably result in higher unemployment.

7. Institutional guarantees for sound macroeconomic policy

Both monetary and fiscal policies are vulnerable to populist pressures coming from the political scene, especially in post-communist countries where young democratic systems are not mature yet. Hence, the role of institutional guarantees, including constitutional regulations, is very important. Among the many issues which require serious discussion, two will be concentrated on: central bank independence, and constitutional guarantees of responsible fiscal policy.

7.1. Central Bank independence

After the 1989 and 1991 legislative changes, the NBP now enjoys partial legal independence, particularly in relation to the government. The governor of the NBP is designated by the President and appointed by the Sejm (lower house of the Polish parliament) for a fixed 6 year term. In practice, they cannot be fired during this term. However, other attributes of central bank independence are not fully in place. First, the Law on the NBP does not define price stability as its main statutory goal. Second, the monetary program for each year is subject to parliamentary debate and approval. Third, the Parliament can oblige the NBP to buy treasury bills on the primary market which happened regularly up to 1994. (It was put into the budget law for each year). Fourth, according to very unclear legal regulations, the NBP must share the responsibility for the exchange rate policy with Minister of Finance and the Minister of Foreign Economic Cooperation (to be Minister of Economy as of January 1, 1997).

Apart from the legal uncertainties over the last two years, Poland's central bank is permanently threatened by the parliamentary majority with a new law on the NBP that may decrease its level of autonomy. This kind of political blackmailing influences the behavior of the central bank leadership.

Sound monetary policy needs a thoroughly independent central bank. As well, Poland's future membership in the EU will be connected with respecting basic European institutional standards where the issue of an independent central bank has the highest priority. German Federal Bank (*Bundesbank*) should be considered as the best institutional pattern for the NBP. Some key regulations on the goals and functions of the NBP, stability of its leadership (to be decided independently whether to be one person or collective management), the exclusive responsibility in the field of monetary and exchange rate policy should be written down in the new Constitution.

The institutional allocation of the banking supervision (BS) authority is another controversial question. Usually, leaving the NBP with the responsibility for BS is associated with support for greater independence of the central bank, while the proposal to separate BS from NBP is seen as an attempt to question this independence. In reality, the arguments for and against are more complicated and under certain circumstances, the central bank's responsibilities for BS can be in conflict with its mission to guarantee a price stability (Cukierman, 1995). The bailing out of several commercial banks by the NBP in 1993-1994 can serve as empirical justification of this doubt.

In actuality, arguments in favor of continuing NBP responsibility for BS still seem to prevail over the alternative proposal. When a significant part of the banking sector is still state owned, government responsibility for BS is connected with the danger of "schizophrenic" behavior and excessive politicization. Also, the information argument, that BS is using the same information base as the monetary authorities, plays the important role. Hence a compromise proposal, i.e., autonomous BS authority under the NBP supervision may be the best solution for the next decade (Kostrzewa, 1996).

7.2. Institutional guarantees for fiscal responsibility

The main danger of fiscal irresponsibility by the parliament or the government comes from the conflict between the limited time horizon of political motivation and the long term financial consequences of many decisions, particularly those related to the pension system and other social entitlements (which once established have big political and legal inertia[10]). Hence the necessity to build up some constitutional and legal guarantees for fiscal responsibility. The following measures should be taken into considerations:

– quantitative limits on the maximum level of fiscal deficit and public debt (for example, those of the Maastricht treaty);

– prohibition of direct financing of the budget deficit by the central bank (including buying treasury bills on the primary market) and quasi-fiscal operation of the central bank;

– the rule that the government has exclusive legislative initiative in all cases involving direct and indirect fiscal implications; government must approve all proposals and amendments raised during the legislation process which lead either to a decrease in revenues or an increase in expenditures;

– the rule that, inside the government, all decisions having fiscal implications must be approved by the Minister of Finance;

– improving fiscal accounting rules; following the example of the Fiscal Responsibility Act in New Zealand, the government and parliament should be obliged to present long term fiscal consequences of the adopted decisions and regulations; government should publish regularly the long term fiscal projections including all existing liabilities connected with pension schemes, investment programs, public debt restructuring, etc.; fiscal accounting and statistics should present not only cash but accrual balances as well.

8. Final remarks

Poland's transition process needs a new push forward. This concerns all its aspects — privatization, deregulation, institutional reforms, microeconomic restructuring, and macroeconomic policy. In this last area, bigger progress in curbing still excessive inflation is of key importance for the prospects of economic growth and smooth accession of Poland to the EU. If central bank and government do not succeed in this respect, Poland will face the danger of long term economic stagnation and "second class" membership status in the EU.

To achieve low inflation and maintain high growth rates, Poland needs prudent monetary and fiscal policies. A stable exchange rate, control of the money supply, interest rate policies supporting demand for money, zero or very low fiscal deficit, significant downsizing of government expenditures, tax reductions, the elimination of fiscal distortions, and avoiding the corporative solutions and collective bargaining in wage setting are all key macroeconomic policy recommendations. Crucial as well, is the need to strengthen the independence of the NBP and to introduce basic guarantees of fiscal responsibility.

There are also very clear links with progress in the sphere of microeconomic and institutional reforms. Real fiscal consolidation is not possible without fundamental changes in pension system, health care, education, social aid, and other spheres of the public sector. Fast privatization and enterprise restructuring, and maintaining competitive markets will be of equal importance for the prospects of economic growth and successful disinflation. Preserving a large sector of public enterprises will decrease overall productivity and will threaten progress by maintaining populist pressures on fiscal and monetary policies. This means that progress in the macro and micro spheres is strongly interrelated.

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[10] Polish experience shows that decision to correct excessive (from the fiscal point of view) social entitlements even if can be eventually approved by parliament can be effectively questioned by the constitutional court on the ground that state violated its commitments in relation to citizens.

Tables and graphs

Table 1
Real GDP (annual percentage change)

	1989	1990	1991	1992	1993	1994	1995	cummulative	
Central and Eastern Europe									
Albania	9.8	-10.0	-28.0	-7.2	9.6	9.4	8.6	1989-96	-14.0
Belorus	...	...	-1.2	-9.7	-10.6	-12.6	-10.2	1991-95	-37.4
Bulgaria	-0.5	-9.1	-11.7	-7.3	-2.4	1.4	2.5	1989-95	-24.9
Croatia	...	...	...	...	-3.7	0.8	5.0	1993-96	1.9
Czech Republic	...	...	...	...	-0.9	2.6	5.0	1993-95	6.8
Czechoslovakia	4.5	-0.4	-15.9	-8.5	...	...	...	1989-92	-19.9
Estonia	...	...	-7.9	-21.6	-8.4	3.0	4.0	1991-95	-29.1
Hungary	0.7	-3.5	-11.9	-3.0	-0.8	2.9	1.9	1989-95	-13.6
Latvia	...	...	-11.1	-35.2	-16.1	2.2	0.4	1991-95	-50.4
Lithuania	...	...	-13.1	-56.6	-24.2	1.7	5.3	1991-95	-69.4
Macedonia	...	...			-8.4	-8.2	-3.0	1993-95	-18.4
Moldova	...	...	-17.5	-29.1	-1.2	-31.2	-3.0	1991-95	-61.4
Poland	**0.2**	**-11.6**	**-7.0**	**2.6**	**3.8**	**6.0**	**6.5**	**1989-95**	**-1.0**
Romania	-5.8	-5.6	-12.9	-8.8	1.3	3.9	6.9	1989-95	-20.5
Slovak Republic	...	...	...	...	-3.7	4.9	7.4	1993-95	8.5
Slovenia	...	...	...	...	1.3	5.3	4.8	1993-95	11.8
Ukraine	...	...	-11.9	-17.0	-16.8	-23.7	-11.4	1991-95	-58.9
Russia	...	...	-13.0	-19.0	-12.0	-15.0	-4.0	1991-95	-49.4
Transcaucasus and central Asia									
Armenia	...	...	-12.4	-52.6	-14.1	5.4	5.0	1991-95	-60.5
Azerbaijan	...	...	-0.7	-22.1	-23.1	-20.8	-13.2	1991-95	-59.1
Georgia	...	...	-20.6	-44.8	-25.4	-11.4	-5.0	1991-95	-72.5
Kazakstan	...	...	-13.0	-14.0	-12.0	-25.0	-11.0	1991-95	-56.1
Kyrgyz Republic	...	...	-7.9	-13.9	-15.5	-20.1	1.3	1991-95	-45.8
Mongolia	4.2	-5.6	-9.2	-9.5	-3.0	2.3	6.3	1989-95	-14.7
Tajikistan	...	...	-7.1	-28.9	-11.1	-21.4	-12.5	1991-95	-59.6
Turkmenistan	...	...	-4.7	-5.3	-10.0	-20.0	-13.9	1991-95	-44.1
Uzbekistan	...	...	-0.5	-11.1	-2.3	-4.2	-1.2	1991-95	-18.2

Source: World Economic Outlook, IMF.

Table 2

Consumer prices (annual average percentage change)

	1989	1990	1991	1992	1993	1994	1995
			Central and Eastern Europe				
Albania	...	...	35.8	225.2	85	22.6	7.8
Belorus	...	...	83.5	966	1188	2220	709
Bulgaria	6.4	23.9	333.5	82	72.8	96	62.1
Croatia	...	...	...	...	1516	96.5	2.1
Czech Republic	...	...	...	...	20.8	10	9.1
Czechoslovakia	1.4	10.8	59	11	...	...	...
Estonia	...	...	210.6	1069	89	47.8	28.9
Hungary	16.9	29	34.2	23	22.5	18.8	28.2
Latvia	...	...	124.4	951.3	109	35	25
Lithuania	...	...	224.7	1020.5	410.4	72.1	36.5
Macedonia	...	...	...	...	334.5	122.6	16.1
Moldova	...	...	162	1276	788.5	329.6	30.2
Poland	**224.3**	**805.1**	**78.8**	**45.4**	**37.1**	**33.3**	**28.4**
Romania	0.9	4.7	161.1	210.3	256	136.8	32.3
Slovak Republic	...	...	...	...	23	13.4	9.9
Slovenia	...	...	...	...	32.3	19.8	12.1
Ukraine	...	...	91.2	1209.7	4734.9	891	376
Russia	...	...	92.7	1353	896	302	190.2
			Transcaucasus and central Asia				
Armenia	...	...	100.3	824.5	3731.8	5273.4	175.6
Azerbaijan	...	...	105.6	912.6	1029.7	1664.4	411.7
Georgia	...	...	78.5	887.4	3125.4	17271.5	169.3
Kazakstan	...	...	91	1381	1662.3	1879.9	176
Kyrgyz Republic	...	...	85	854.6	1208.8	278.1	42.8
Mongolia	...	...	20.2	202.6	268.4	87.6	56.8
Tajikistan	...	...	111.6	1156.7	2194.9	350.4	635.4
Turkmenistan	...	...	102.5	492.9	3102.4	1748	1261.5
Uzbekistan	...	...	105	644.7	534.2	1568	305

Source : World Economic Outlook, IMF.

Table 3

Consumer prices (end-year; annual percentage change)

	1991	1992	1993	1994	1995	1996 projection
			Central and Eastern Europe			
Albania	104	237	31	16	6	6
Belarus	93	1558	1994	1957	340	80
Bulgaria	339	79	64	122	33	30
Croatia	149	937	1150	-3	4	5
Czech Republic	52	13	18	10	8	7
Estonia	304	954	36	42	29	22
Hungary	32	22	21	21	28	22
Latvia	262	958	35	26	23	20
Lithuania	345	1175	189	45	36	30
Macedonia	115	1935	230	55	9	6
Moldova	151	2198	837	116	24	16
Poland	**60**	**44**	**38**	**29**	**22**	**19**
Romania	223	199	296	62	28	20
Slovak Republic	58	9	25	12	7	7
Slovenia	247	93	23	18	9	6
Ukraine	161	2000	10155	401	180	60
Russia	144	2318	841	203	131	45
			Transcaucasus and central Asia			
Armenia	25	1341	10996	1885	25	20
Azerbaijan	126	1395	1294	1788	86	30
Georgia	131	1176	7488	8279	25	20
Kazakstan	150	2567	2189	1160	60	30
Kyrgyz Republic	170	1771	1366	87	32	25
Tajikistan	204	1364	7344	5	1350	500
Turkmenistan	155	644	9750	1100	2500	500
Uzbekistan	169	910	885	1281	115	40

Source: Transition Report Update, April 1996, EBRD.

Table 4
Official exchange rate (zlotys per USD; monthly averages)

	March	June	September	December
1989	0.06	0.08	0.13	0.52
1990	0.95	0.95	0.95	0.95
1991	0.95	1.14	1.12	1.11
1992	1.34	1.37	1.38	1.54
1993	1.66	1.74	1.96	2.11
1994	2.20	2.26	2.31	2.43
1995	2.39	2.34	2.46	2.51
1996	2.58	2.71	2.78	...

Source: International Financial Statistics, IMF ; NBP.

Table 5
Nominal exchange rates (monthly averages)

Natioal currency of:	A	B	C	D	E	F		G	H		I
per 1:	USD	USD	USD	USD	USD	USD	DEM	USD	SDR	USD	USD
1989 MAR	0.06	54.99	...	...	...	...	...	...	...	...	...
1989 JUN	0.08	62.43	...	...	...	...	...	...	...	...	...
1989 SEP	0.13	61.06	...	...	...	...	...	...	...	...	...
1989 DEC	0.52	62.63	...	...	...	...	...	...	...	...	...
1990 MAR	0.95	65.68	...	...	...	...	...	...	...	...	...
1990 JUN	0.95	65.02	...	...	...	...	...	...	...	...	...
1990 SEP	0.95	62.35	...	...	...	...	...	...	...	...	...
1990 DEC	0.95	60.95	...	...	...	...	...	...	...	...	...
1991 MAR	0.95	72.65	...	...	...	...	...	...	...	...	...
1991 JUN	1.14	76.98	...	...	...	...	...	...	...	...	...
1991 SEP	1.12	75.49	...	...	...	...	...	...	...	...	...
1991 DEC	1.11	76.78	...	...	57.73	...	...	...	...	...	...
1992 MAR	1.34	79.64	...	...	82.24	...	...	1.25	0.79	0.58	...
1992 JUN	1.37	78.46	...	...	80.67	12.42	8.00	1.46	0.90	0.63	...
1992 SEP	1.38	77.39	...	...	82.05	11.58	8.00	2.50	1.17	0.80	...
1992 DEC	1.54	82.92	...	...	96.15	12.65	8.00	3.79	1.15	0.84	0.80
1993 MAR	1.66	87.12	29.21	29.04	103.81	13.19	8.00	4.88	0.95	0.68	1.56
1993 JUN	1.74	90.27	29.15	29.07	114.24	13.15	8.00	4.00	0.89	0.66	3.20
1993 SEP	1.96	93.46	32.15	28.84	115.06	13.00	8.00	3.93	0.84	0.62	5.94
1993 DEC	2.11	99.97	32.97	29.76	129.37	13.68	8.00	3.90	0.82	0.60	6.56
1994 MAR	2.20	103.04	32.80	29.59	132.41	13.54	8.00	4.00	0.80	0.57	6.14
1994 JUN	2.26	102.85	32.15	28.89	129.92	13.06	8.00	4.00	0.80	0.55	5.87
1994 SEP	2.31	108.28	31.25	27.98	124.39	12.41	8.00	4.00	0.80	0.55	5.73
1994 DEC	2.43	111.60	31.47	28.22	128.08	12.57	8.00	4.00	0.80	0.55	5.63
1995 MAR	2.39	116.16	29.40	26.22	115.36	11.25	8.00	4.00	0.81	0.52	5.00
1995 JUN	2.34	125.47	29.43	26.14	114.00	11.21	8.00	4.00	0.80	0.51	5.04
1995 SEP	2.46	133.66	30.13	26.93	120.51	11.70	8.00	4.00	0.80	0.53	5.26
1995 DEC	2.51	139.07	29.71	26.66	125.58	11.52	8.00	4.00	0.80	0.54	5.32
1996 MAR	2.58	146.04	30.18	27.26	132.34	11.82	8.00	4.00	0.80	0.55	5.46
1996 JUN	2.71	152.79	...	27.80	139.29	12.21	8.00	4.00	...	...	5.44
1996 SEP	2.78	...	...	26.54	...	12.04	8.00	4.00	...	...	5.43

A = Poland; B = Hungary; C = Slovak Republic; D = Czech Republic; E = Slovenia; F = Estonia; G = Lithuania; H = Latvia; I = Croatia

Source: International Financial Statistics, IMF.

Table 6
Money supply structure (end of the period)

	Broad money		Domestic money		Currency in circulation		Nonfinancial sector deposits in domestic currency		Nonfinancial sector deposits in foreign currency	
	bln of zlotys	growth in %**	bln of zlotys	growth in %**	bln of zlotys	growth in %**	bln of zlotys	growth in %**	bln of zlotys	growth in %**
1989	9.58	...	2.64	...	0.99	...	1.65	...	6.95	...
1990	19.06	98.9	13.08	396.3	3.93	298.1	9.14	455.2	5.98	-13.9
1991	26.10	36.9	19.65	50.3	5.62	42.8	14.04	53.5	6.45	7.8
1992	41.12	57.5	30.93	57.4	7.80	38.8	23.13	64.8	10.19	58.0
1993	55.92	36.0	39.83	28.8	9.98	27.9	29.85	29.1	16.09	57.9
1994	77.30	38.2	55.24	38.7	12.27	22.9	42.97	43.9	22.06	37.1
1995	104.26	34.9	82.96	50.2	19.53	59.2	63.43	47.6	21.30	-3.4
1996*	123.23	18.2	100.84	21.6	23.01	17.8	77.83	22.7	22.39	5.1

* Three quarters of 1996.
** Percentage growth in comparison to the previous year.
Source: NBP.

Table 7
Selected monetary indicators for Poland

	Money velocity (M2 incl. foreign currency deposits)	Money velocity (M2 excl. foreign currency deposits)	Monetary base (in bln of zlotys)	Monetization (M2 with foreign currency deposits)
1989	1.23	4.49	2.83	0.81
1990	3.10	4.52	8.34	0.32
1991	3.16	4.20	11.01	0.32
1992	2.80	3.72	14.73	0.36
1993	2.78	3.91	16.65	0.36
1994	2.78	3.89	23.56	0.36
1995	2.81	3.53	28.40	0.36

Source: World Economic Outlook; International Financial Statistics, IMF; NBP.

Table 8
Domestic money (M2) velocity

	Hungary	Poland	Bulgaria	Romania	Czech Republic	Slovak Republic	Slovenia	Estonia
1989	2.70	4.49	...	...	...	...	...	...
1990	2.62	4.52	1.05	1.72	...	...	...	...
1991	2.54	4.20	1.98	2.22	1.60	1.41	5.66	...
1992	2.28	3.72	1.71	3.96	1.46	1.50	6.76	3.58
1993	2.49	3.91	1.60	6.31	1.37	1.51	6.08	3.72
1994	2.74	3.89	1.93	6.01	1.28	1.52	4.66	3.67
1995	3.18	3.53	2.01	5.10	1.25	1.48	3.40	3.82

Source: International Financial Statistics, IMF

Table 9
Structure of nonfinancial sector deposits (foreign currency deposits in zlotys at the official NBP exchange rate)

	Ratio of foreign currency deposits to all deposits	Ratio of foreign currency deposits to zloty deposits
1989	0.81	4.22
1990	0.40	0.65
1991	0.31	0.46
1992	0.31	0.44
1993	0.35	0.54
1994	0.34	0.51
1995	0.25	0.34
1996*	0.22	0.29

*Three quarters of 1996.
Source: NBP.

Table 10
Interest rates on 3- and 12-month deposits in major commercial banks vs. past 12 months' inflation (lower and upper bounds of interest rates in annual terms annual inflation index: end of the quarter current year to end of the quarter last year)

	3-month deposits		12-month deposits		Inflation
	lower bound	upper bound	lower bound	upper bound	
1990 DEC	40	55	56	65	225.9
1991 MAR	60	72	73	85	91.0
1991 JUN	45	61	60	72	82.2
1991 SEP	30	42	42	54	71.4
1991 DEC	30	41	38	52	60.3
1992 MAR	30	43	38	56	42.4
1992 JUN	30	45	38	58	41.1
1992 SEP	30	38	38	49	47.3
1992 DEC	30	37	38	52	44.4
1993 MAR	20	35	34	43	42.1
1993 JUN	20	35	34	40	37.0
1993 SEP	20	35	34	40	32.5
1993 DEC	20	31	32	38	37.7
1994 MAR	20	31	32	38	31.6
1994 JUN	20	30	29.5	37	33.4
1994 SEP	22	29	29	36	35.7
1994 DEC	22	28	27.7	33	29.4
1995 MAR	22	28.6	27	35	33.2
1995 JUN	20	25	22.5	30	30.9
1995 SEP	18	24	22	28	24.4
1995 DEC	18	22.1	22	25	21.9
1996 MAR	16.5	19.5	19	22.5	20.2
1996 JUN	16.5	19.2	19	22.5	19.6

Source: NBP.

Table 11

Fiscal policy in Poland, 1989-1995 (structure of revenues, expenditures, and financing of fiscal deficit as % of GDP)

	1989	1990	1991	1992	1993	1994	1995
1. Government revenues	33.83	47.31	42.27	45.14	47.64	48.30	47.18
2. Government expenditure	39.86	43.59	48.94	51.80	49.94	50.49	49.78
3. Government balance	-6.03	3.71	-6.67	-6.66	-2.30	-2.19	-2.61
4. Domestic financing of the fiscal deficit	6.26	-3.00	6.78	6.91	2.68	4.14	2.42
5. External financing of the fiscal deficit	-0.23	-0.72	-0.12	-0.25	-0.38	-1.95	0.20
6. Public debt	...	...	...	...	64.80	56.40	51.40
7. Total external debt	53.52	82.24	63.33	55.74	55.09	45.55	37.39
8. Corporate taxes	7.89	15.23	6.91	4.55	4.24	3.42	3.14
9. Individual taxes	4.19	4.77	5.77	8.86	9.65	9.93	9.67
10. VAT or turnover	7.20	6.70	7.60	9.00	11.40	12.90	12.90
11. Social security contributions:	8.70	11.40	10.50	11.40	11.00	10.70	11.09
12. Taxes- internat trade transac:	0.00	0.66	2.11	2.33	2.81	2.32	1.99
13. Other taxes	2.29	2.85	2.76	2.00	1.60	1.50	1.53
14. Profit from the Central Bank	1.47	1.77	0.82	1.05	0.91	1.12	1.13
15. Capital revenues	0.00	0.30	0.21	0.42	0.79	1.10	1.10
16. Expenditures on Goods & Services	2.49	4.84	7.75	6.24	4.38	3.28	6.42
17. Expenditures on Wages and salaries	4.18	4.43	6.18	8.08	7.92	9.88	8.48
18. Interest payments	0.00	0.40	1.55	3.14	3.83	4.39	5.28
19. Subsidies	10.56	7.70	5.12	3.27	3.87	4.08	1.79
20. Transfers	16.35	18.91	20.70	19.94	20.59	21.62	21.04
21. Capital Expenditures	3.44	3.86	3.23	3.42	3.27	3.07	2.53
22. Other Expenditures	0.00	0.00	0.00	0.00	0.00	0.00	0.00

Sources: MultiQuery Database: A Tool for Cross-Country Comparisons. Europe and Central Asia Region. The World Bank, Spring 1996.

Table 12

Revenues and expenditures of general government in Central European countries. Percentage shares of nominal GDP

	1989	1990	1991	1992	1993	1994	1995	Change 1989-1995*
Poland								
Revenues	33.8	47.3	42.3	45.1	47.6	48.3	47.2	+13.4
Expenditures	39.9	43.6	48.9	51.8	49.9	50.5	49.8	+9.9
Hungary								
Revenues	59.2	57.6	51.9	55.2	54.9	54.6	51.3	-7.9
Expenditures	60.5	57.2	54.0	60.6	61.6	62.1	55.3	-5.2
Czechoslovakia								
Revenues	56.8	49.3	50.0					
Expenditures	58.9	49.5	52.2					
Czech Republic								
Revenues				48.2	51.4	51.2	50.4	-6.4
Expenditures				47.8	50.1	50.7	49.8	-9.1
Slovak Republic								
Revenues				46.1	44.2	46.4	47.9	-8.9
Expenditures				58.0	51.2	47.7	47.3	-11.6
Slovenia**								
Revenues	42.7	.....	43.7	46.4	47.1	47.3	45.9	+3.2
Expenditures	40.6	.....	41.1	46.2	46.8	47.5	46.2	+5.6

* The changes between 1989 and 1995 for the Czech and Slovak Republic and for Slovenia are the approximations due to relative incomparability of 1989 data — for the Czech and Slovak Republic these refer to Czechoslovakia; for Slovenia — to Yugoslavia.

** Data for 1989 refer to Yugoslavia.

Sources: MultiQuery Database: A Tool for Cross-Country Comparisons. Europe and Central Asia Region. The World Bank, Spring 1996. Data for Czechoslovakia and Yugoslavia: Government Finance Statistics. IMF, 1994.

Table 13
Scenarios assumptions

	Common assumptions for all the scenarios	
	Period 1996-2000	***Period 2001-2005***
Membership in EU	Negotiations in 1998-2000	Membership starting from 2001
Debt to Paris and London Clubs	Interest payments — ca. USD 1.4 bn per year; principals increasing up to USD 0.7 bn in 2000	Interest payments — ca. USD 1.3 bn per year, principals increasing up to USD 3.7 bn in 2005
Economic activeness	Modest growth in Western Europe (annual growth of GDP by 3%)	Modest growth in Western Europe (annual growth of GDP by 3%)
Labor supply	Average annual growth by 0.2%	Average annual growth by 0.2%
Number of pensioners	Average annual growth by 3.21%	Average annual growth by 3.21%
Real domestic interest rate	Stable on the level of 2%	Stable on the level of 2%
LIBOR (12 months deposits in USD)	Stable on the level of 7.5%	Stable on the level of 7.5%
Import tariffs (in relation to EU countries)	Decrease up to 0% in 2000	Free trade (apart from agriculture products)
Devaluation	To guarantee official reserves on the level of 6 months import	To guarantee official reserves on the level of 6 months import
	Scenario of stopped reforms	
	Period 1996-2000	***Period 2001-2005***
Disinflation	Slow disinflation up to the level of 16%	Stabilization on the level of 15%
Transfers from EU	PHARE transfers (ca. USD 250 mn)	Gradual increase from 1 to 4 bn USD
FDI	USD 1.5 bn per year	Gradual increase up to USD bn 3
Pension system	No reform, indexation formula — 75% of wage increase, 25% of price increase	No reform, indexation formula — 75% of wage increase, 25% of price increase
Tax rates	Unchanged (from 1996)	Unchanched (from 1996)
Employment in budgetary sphere	+1% per year	+1% per year
	Scenario of modest reforms	
	Period 1996-2000	***Period 2001-2005***
Disinflation	Up to 10%	Up to Maastricht level
Transfers from EU	PHARE transfers (ca. USD 250 mn)	Gradual increase from 1 to 4 bn USD
FDI	USD 2 bn per year	Gradual increase up to USD bn 4
Pension system	Partial reform, indexation formula — 50% of wage increase, 50% of price increase	No reform, indexation formula — 50% of wage increase, 50% of price increase
Tax rates	Unchanged (from 1996)	Unchanched (from 1996)
Employment in budgetary sphere	+1% per year	+1% per year
	Scenario of convergence	
	Period 1996-2000	***Period 2001-2005***
Disinflation	Up to 8%	Up to Maastricht level
Transfers from EU	PHARE transfers (ca. USD 250 mn)	Gradual increase from 1 to 2 bn USD
FDI	Gradual increase from 2 to 4 bn USD	Gradual increase from 5 to 7 bn USD
Pension system	Partial reform, indexation formula — 50% of wage increase, 50% of price increase	No reform, indexation formula — 50% of wage increase, 50% of price increase
Tax rates	Unchanged (from 1996)	Unchanched (from 1996)
Employment in budgetary sphere	+1% per year	+1% per year
	Scenario of convergence and growth	
	Period 1996-2000	***Period 2001-2005***
Disinflation	Up to 7%	Up to Maastricht level
Transfers from EU	PHARE transfers (ca. USD 250 mn)	Gradual increase from 1 to 2 bn USD
FDI	Gradual increase from 2 to 4 bn USD	Gradual increase from 5 to 7 bn USD
Pension system	Radical reform, indexation formula — 50% of wage increase, 50% of price increase	Radical reform, indexation formula — 50% of wage increase, 50% of price increase
Tax rates	Unchanged (from 1996)	Decrease of direct taxes rates and of pension payroll tax rate
Employment in budgetary sphere	+0.5% per year	+0.5% per year

Source: Czyżewski and Orłowski (1996).

Table 14
Basic results of scenarios

	1995	Scenarios							
		Stopped reforms		Modest reforms		Convergence		Convergence and growth	
Average annual increase in %		1996-2000	2001-2005	1996-2000	2001-2005	1996-2000	2001-2005	1996-2000	2001-2005
GDP — demand		**5.6%**	**4.2%**	**5.8%**	**4.4%**	**5.7%**	**5.2%**	**5.9%**	**6.0%**
Pace of devaluation		14.2%	9.2%	10.8%	2.0%	8.3%	2.4%	8.1%	2.0%
CPI		18.0%	15.0%	14.2%	5.2%	12.1%	5.0%	11.9%	4.0%
Real M2		5.3%	3.8%	7.3%	5.9%	6.5%	7.0%	6.6%	7.8%
Rate of increase in year	*1995*	*2000*	*2005*	*2000*	*2005*	*2000*	*2005*	*2000*	*2005*
Pace of devaluation	3.3%	13.0%	10.0%	9.0%	0.5%	6.0%	2.0%	5.0%	1.0%
Inflation rate (CPI)	27.8%	16.0%	15.0%	10.0%	3.0%	8.0%	3.0%	7.0%	2.0%
Monetization of the economy (M2/GDP)	37.0%	40.5%	44.2%	42.7%	46.9%	40.8%	45.2%	40.6%	44.8%
Exchange rate zloty/1USD	2.42	4.71	7.31	4.04	4.46	3.60	4.06	3.57	3.94
Official reserves in months of import	6.3	6.0	5.6	5.9	5.9	6.0	5.6	5.9	5.7
Unemployment in % of labor force (BAEL data)	**12.9%**	**10.1%**	**9.6%**	**9.8%**	**9.0%**	**10.5%**	**9.3%**	**11.2%**	**9.8%**
% of GDP									
Current account balance	-1.8%	-1.3%	-0.8%	-1.6%	-1.0%	-2.4%	-2.1%	-2.4%	-2.1%
— trade balance	-1.4%	-0.9%	-2.4%	-1.3%	-2.5%	-2.1%	-2.8%	-2.1%	-2.7%
— transfers from EU	0.2%	0.2%	1.7%	0.2%	1.7%	0.1%	0.8%	0.1%	0.8%
Capital accounts balance	8.8%	1.8%	1.0%	2.0%	1.4%	3.0%	2.5%	3.0%	2.5%
Corrected current account balance (including uregistered trade)	**-0.0%**	**-0.2%**	**-2.2%**	**-0.6%**	**-2.3%**	**-1.6%**	**-2.7%**	**-1.6%**	**-2.6%**
Consolidated budget revenues	**45.1%**	**42.4%**	**41.9%**	**42.4%**	**41.9%**	**42.1%**	**41.4%**	**41.9%**	**40.0%**
— VAT and excise tax	12.8%	12.8%	12.6%	12.7%	12.6%	12.7%	12.4%	12.7%	12.3%
— Custom duties	2.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
— Direct taxes	11.4%	11.4%	11.2%	11.3%	11.2%	11.3%	11.1%	11.3%	11.0%
— Pension contributions	11.4%	11.2%	11.2%	11.4%	11.2%	11.1%	11.1%	11.0%	10.1%
— Other revenues	7.5%	7.0%	6.9%	6.9%	6.8%	6.9%	6.7%	6.9%	6.7%
Consolidated budget expenditure	**47.7%**	**46.4%**	**51.2%**	**44.8%**	**45.8%**	**44.1%**	**43.7%**	**42.0%**	**38.2%**
— budgetary sphere and communes expenditure	17.5%	17.4%	17.3%	17.7%	17.2%	17.4%	17.1%	16.7%	15.1%
— domestic debt service	2.9%	2.2%	4.0%	1.4%	1.0%	1.2%	0.8%	0.8%	0.2%
— external debt service	1.2%	0.9%	0.5%	0.9%	0.5%	0.8%	0.5%	0.8%	0.5%
— pensions	17.5%	18.9%	21.0%	18.1%	19.0%	17.9%	18.5%	16.8%	15.1%
— other current expenditures	7.1%	5.5%	5.1%	5.4%	4.9%	5.5%	4.8%	5.4%	4.4%
— capital expenditures	1.4%	1.4%	3.2%	1.4%	3.2%	1.4%	2.1%	1.4%	3.0%
Fiscal balance	**-2.5%**	**-4.0%**	**-9.2%**	**-2.4%**	**-3.9%**	**-2.0%**	**-2.4%**	**-0.1%**	**1.8%**
Primary deficit	1.6%	-0.9%	-4.6%	-0.2%	-2.4%	-0.0%	-1.1%	1.5%	2.5%
Government savings	-1.1%	-2.5%	-6.0%	-1.0%	-0.8%	-0.6%	-0.3%	1.3%	4.8%
Pension system deficit	-6.1%	-7.7%	-9.8%	-6.7%	-7.8%	-6.8%	-7.4%	-5.8%	-5.0%
Public debt	**59.2%**	**44.7%**	**49.4%**	**42.0%**	**41.2%**	**41.4%**	**35.1%**	**37.0%**	**18.9%**
— domestic	22.1%	18.6%	33.6%	16.6%	25.6%	16.9%	20.2%	12.7%	4.4%
— external	37.1%	26.1%	15.8%	25.4%	15.6%	24.5%	14.9%	24.3%	14.4%

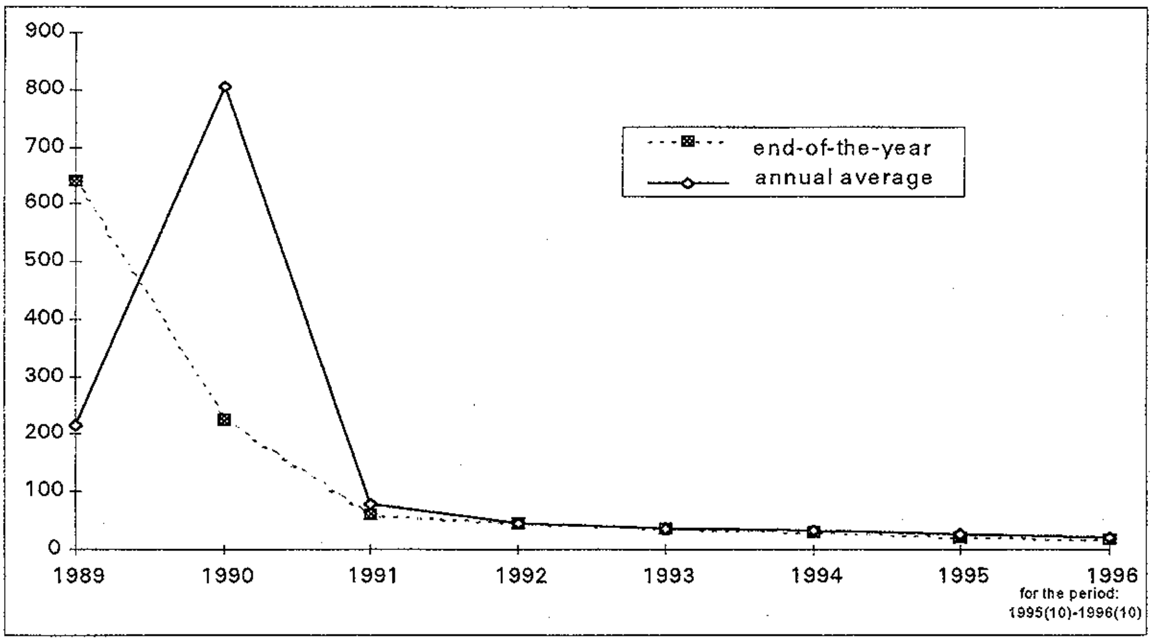
Source: Czyżewski and Orłowski (1996).

Table 15
Poland: balance of payments in convertible currencies in 1990-1995 (in mln USD)

	1990	1991	1992	1993	1994	1995
Current account	**716**	**-1359**	**-269**	**-2329**	**-944**	**-2299**
merchandise exports	10863	12760	13997	13585	16950	22878
merchandise imports	8649	12709	13485	15878	17786	24705
trade balance	2214	51	512	-2293	-836	-1827
services balance	-150	236	344	369	57	150
wealth income balance	0	0	85	100	147	119
interest balance	-3329	-2862	-4139	-3524	-2228	-747
current transfer balance	1981	1217	2929	3019	1916	6
Financial account	**-6654**	**-5305**	**1554**	**575**	**1812**	**10513**
direct investment balance	10	117	284	580	542	1134
portfolio investment balance	...	...	...	...	-624	1171
long term credits extended	42	43	21	11	-11	29
short term credits extended	7	-46	-39	21	-21	-22
long term credit received	-4205	-4632	-1289	-471	-1043	132
IMF credit	479	322	0	-138	610	-1400
other short term capital	-2658	-1117	-434	646	2391	9381
Errors and omissions	**360**	**-713**	**50**	**589**	**-228**	**-27**
Exceptional financing	**7755**	**6569**	**2500**	**1376**	**690**	**17**
Valuation changes	**...**	**-58**	**-254**	**217**	**418**	**731**
Changes in official reserves	**-2177**	**866**	**-473**	**6**	**-1748**	**-8935**
Gross official reserves	*11437*	*13614*	*12748*	*13221*	*13215*	*14963*

Source: NBP.

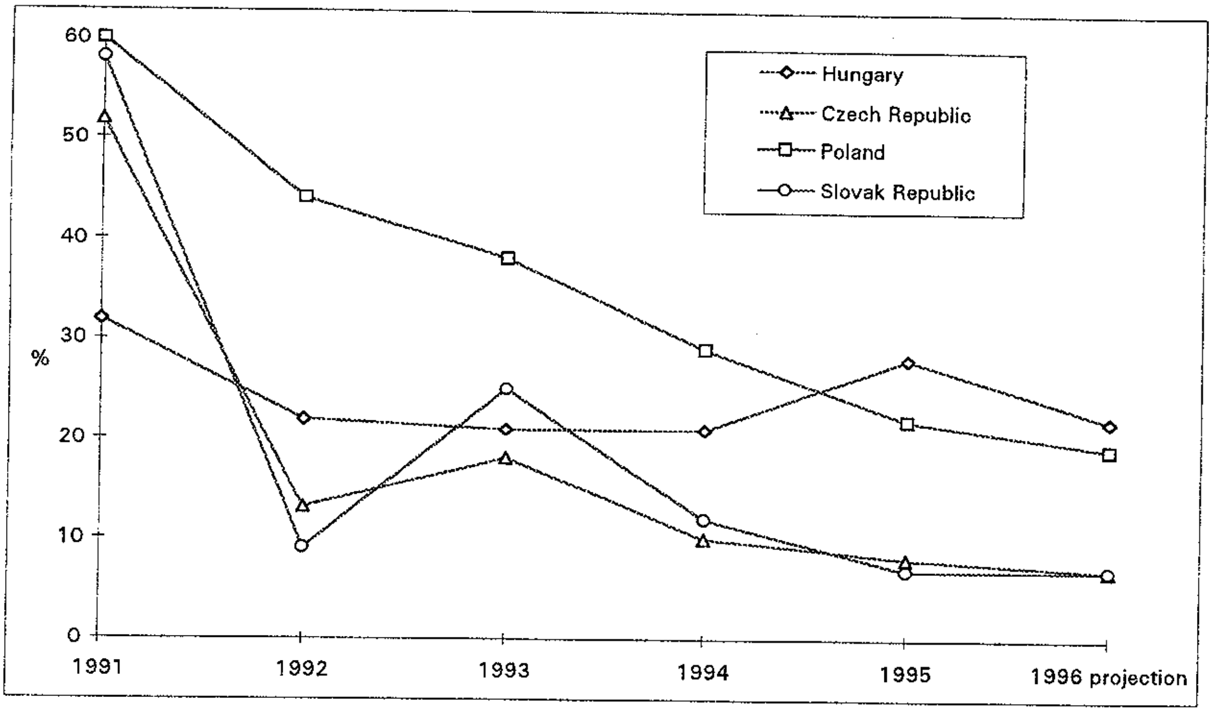
Graph 1
Consumer prices (annual percentage changes)



Source: International Financial Statistics, IMF ; GUS

Graph 2

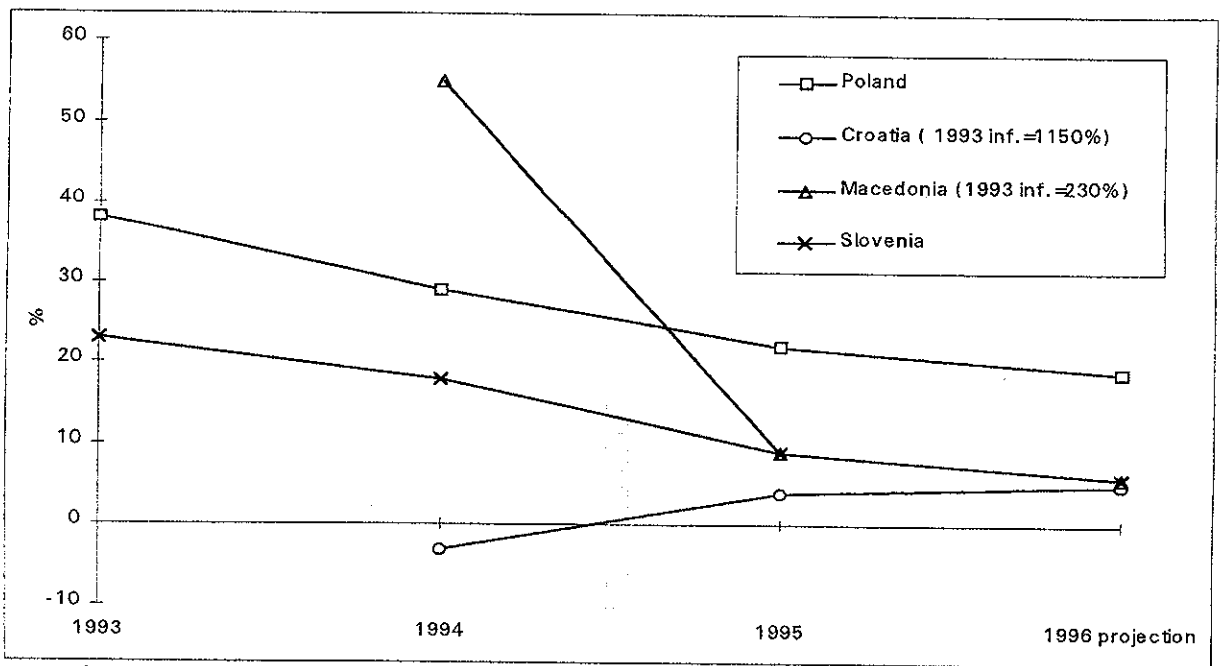
Consumer prices in selected Eastern European countries (end-year annual percentage changes)



Source: Transition Report Update, April 1996, EBRD

Graph 3a

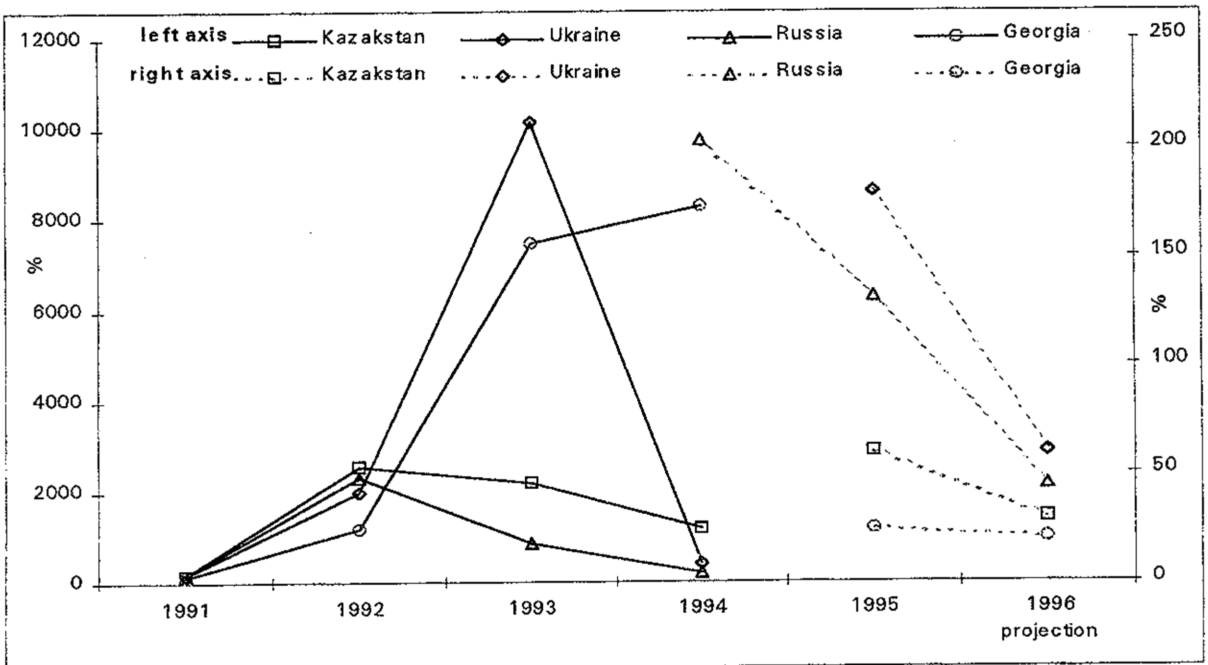
Consumer prices in selected former Yugoslavia countries and Poland (end-year annual percentage changes)



Source: Transition Report Update, April 1996, EBRD.

Graph 3b

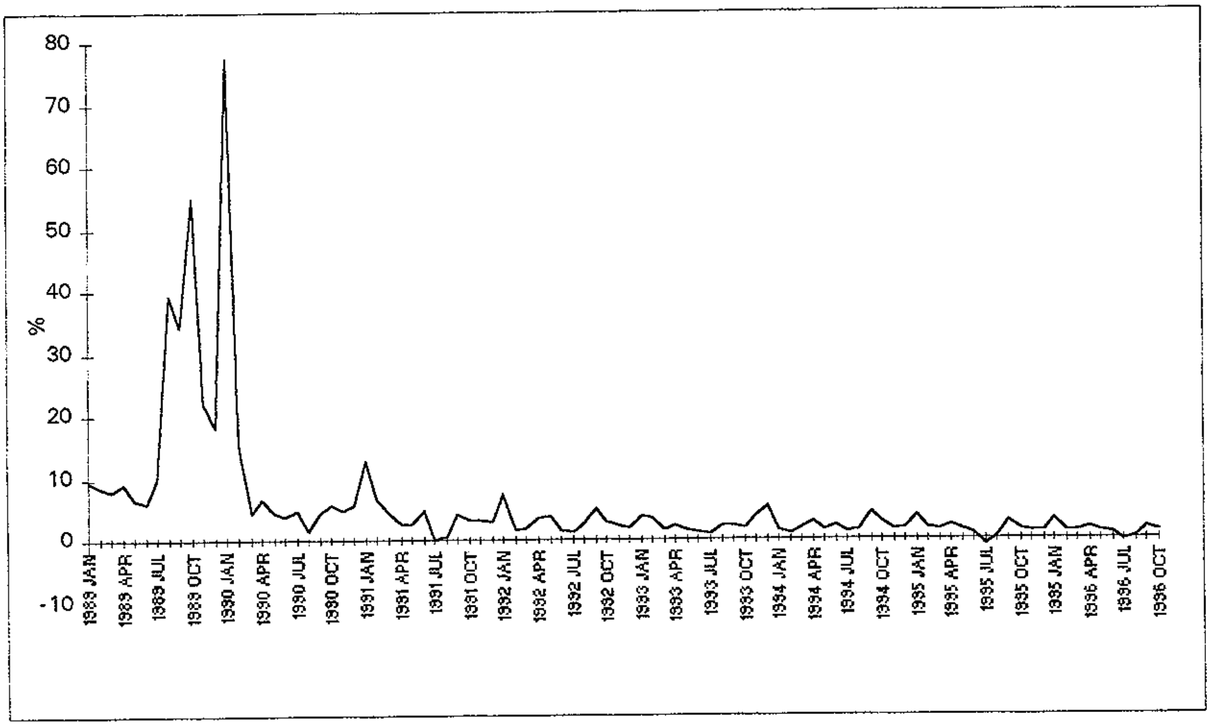
Consumer prices in selected former Soviet Union republics (end-year annual percentage changes)



Source: Transition Report Update, April 1996, EBRD.

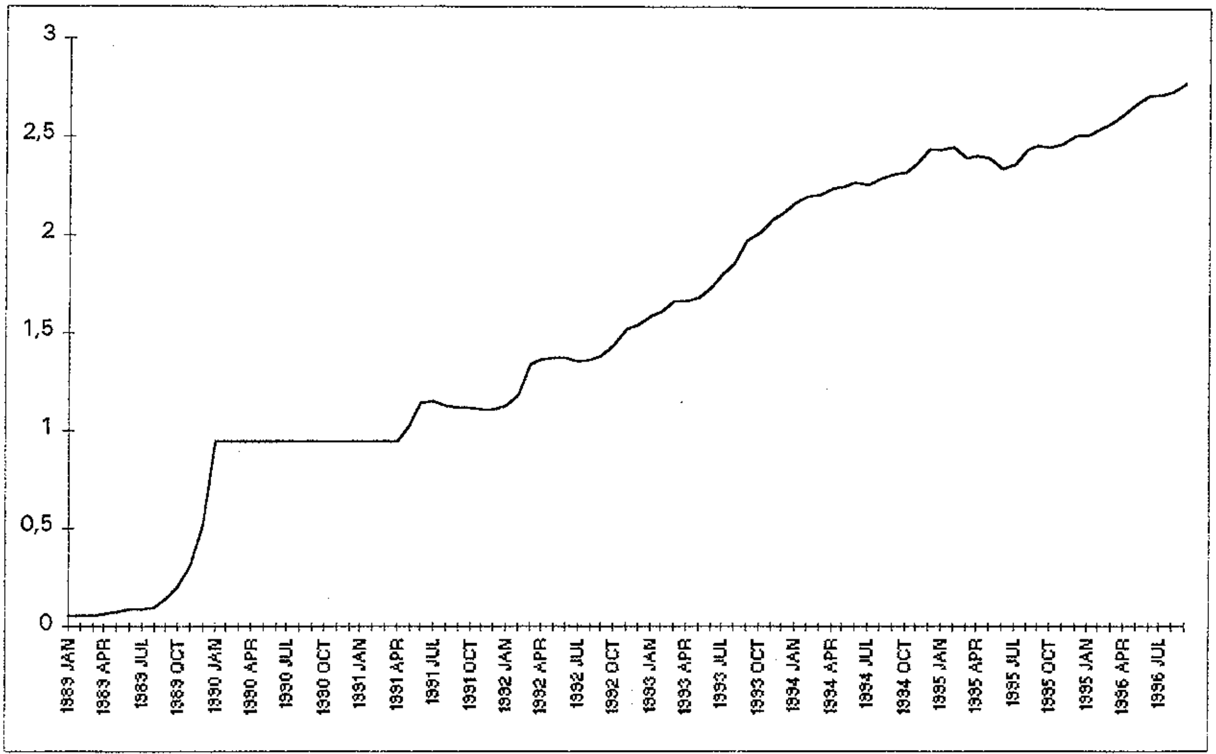
Graph 4

Consumer prices (monthly changes)



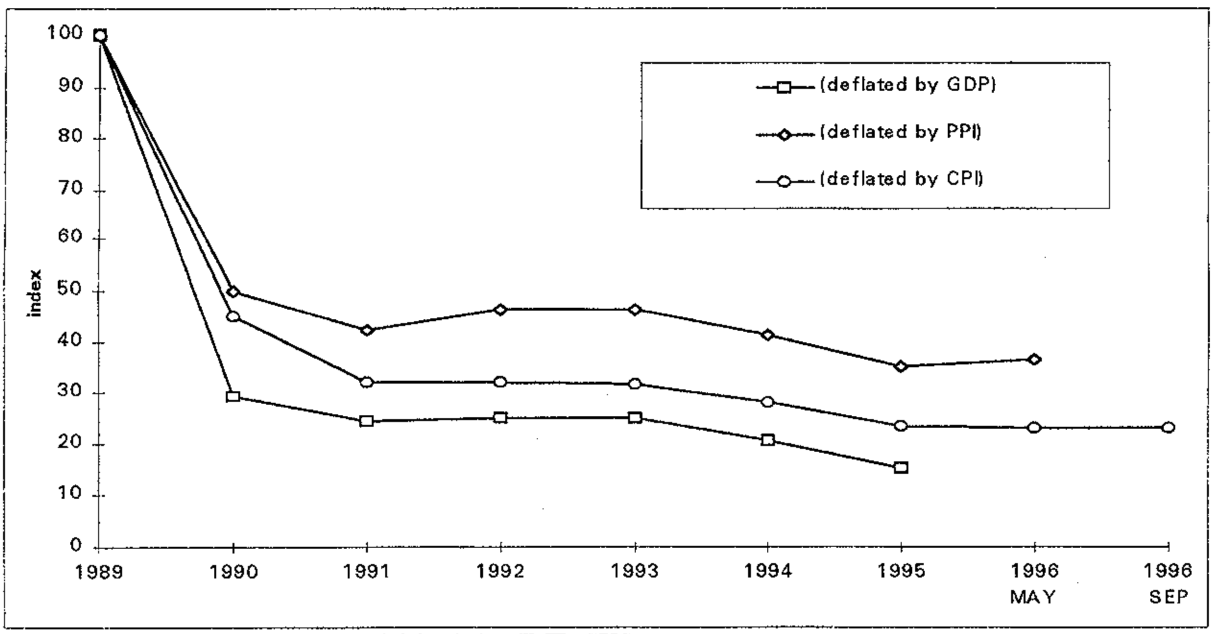
Source: GUS.

Graph 5
Official exchange rate (zlotys per USD; monthly averages)



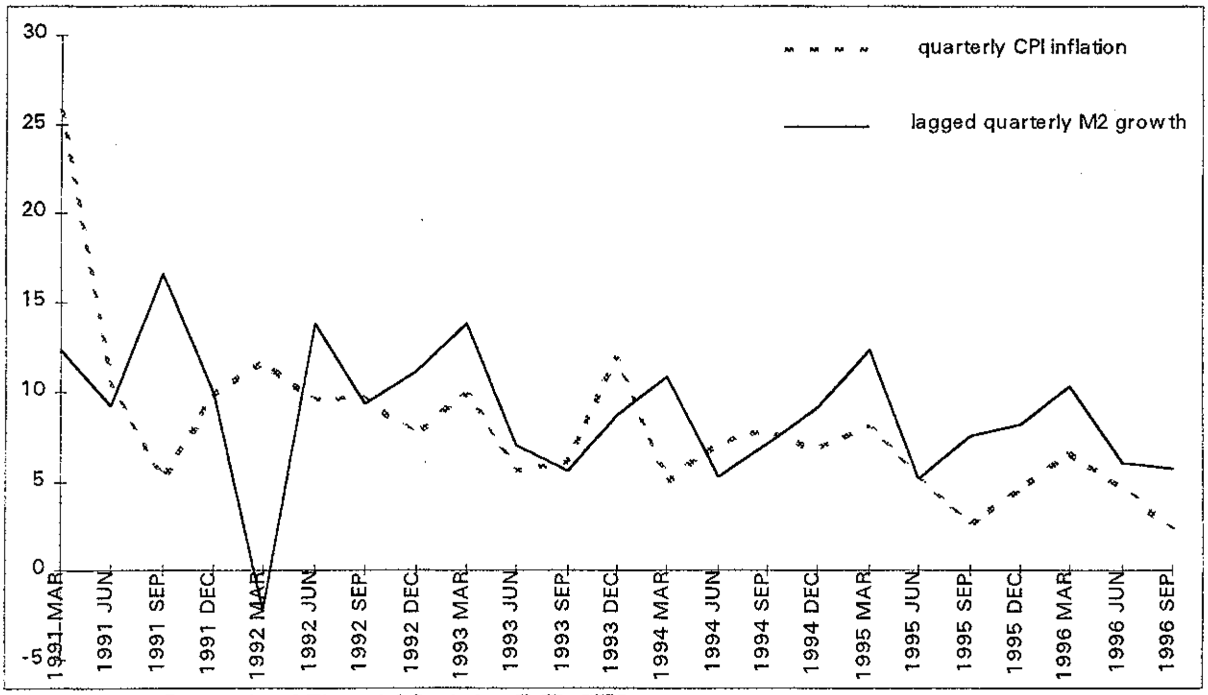
Source: NBP

Graph 6
Real exchange rate index (vis-a-vis USD) based on three different deflators (end-of-the-period index number, 1989=100)



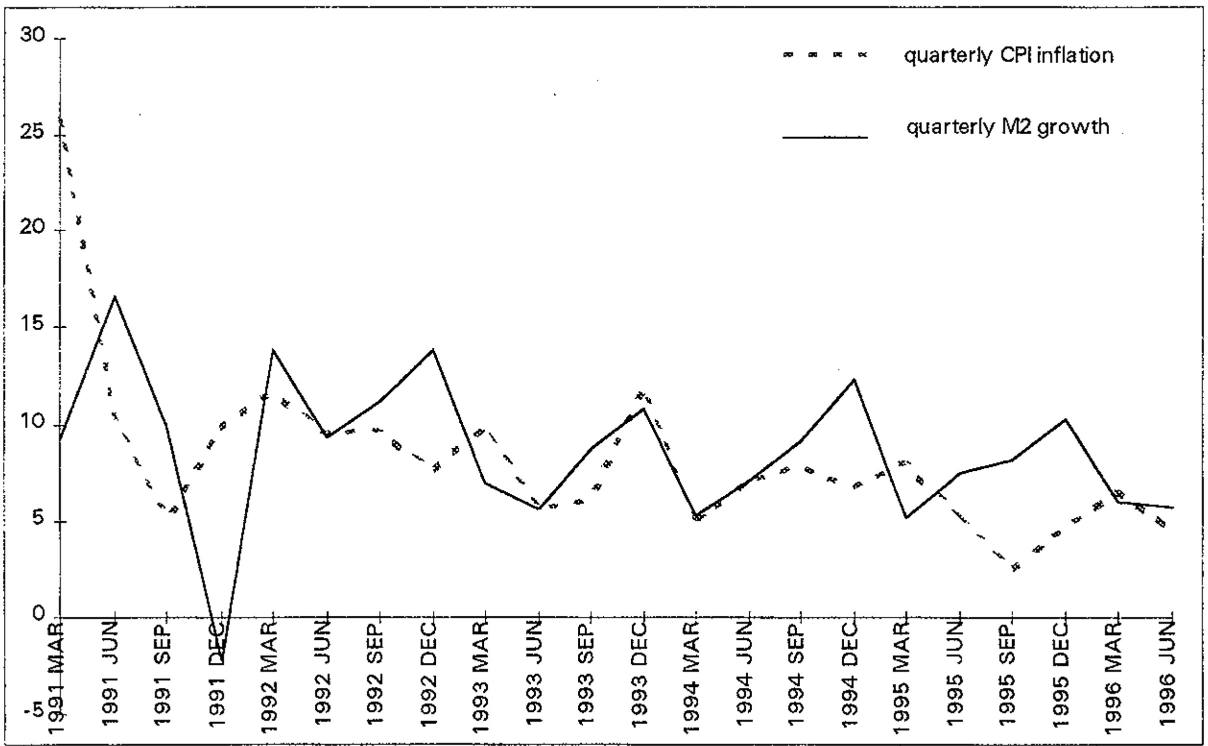
Source: International Financial Statistics, IMF; GUS.

Graph 7a
CPI inflation vs. lagged M2 growth (1 lag) (quarterly changes)



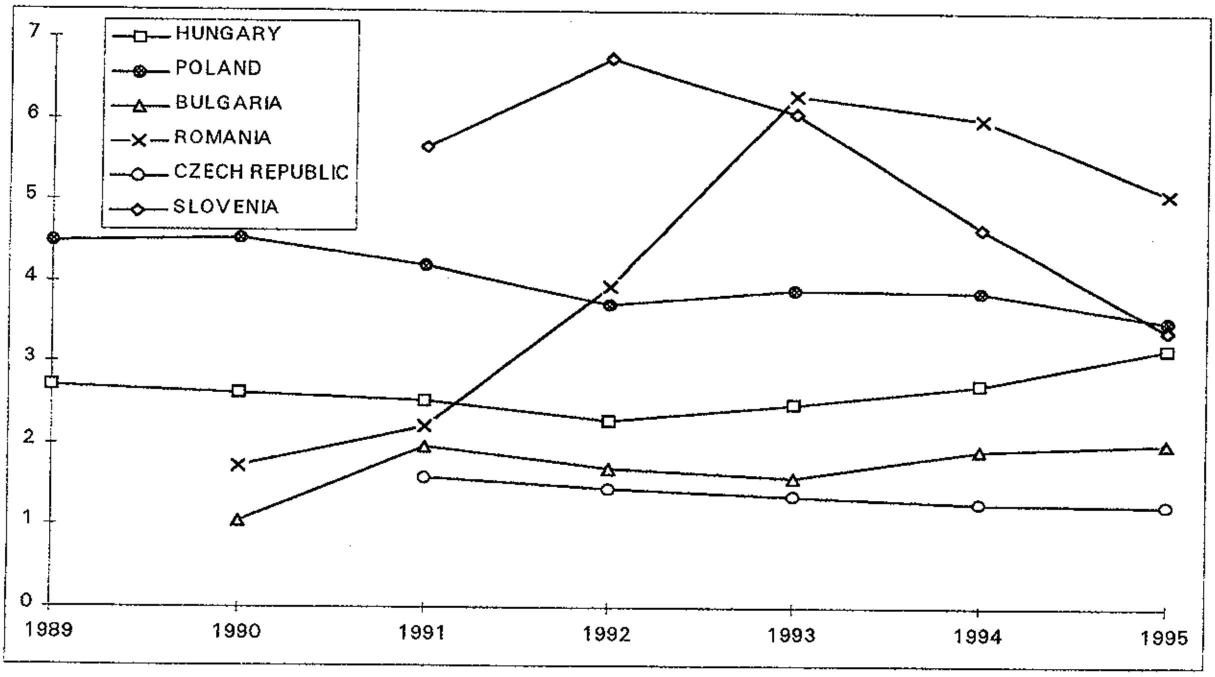
Source: International Financial Statistics, IMF; GUS.

Graph 7b
CPI inflation vs. M2 growth (end-of-the-quarter values changes)



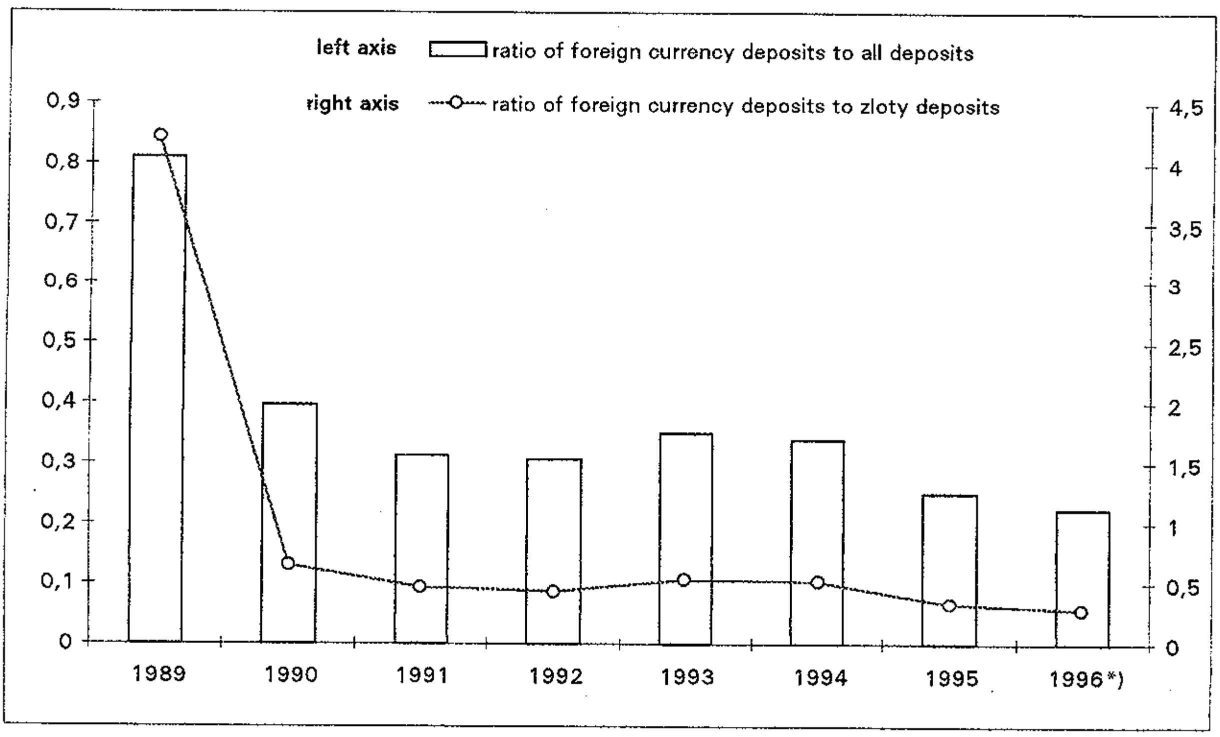
Source: International Financial Statistics, IMF; GUS.

Graph 8
Domestic money (M2) velocity in selected countries



Source: IMF; GUS; NBP.

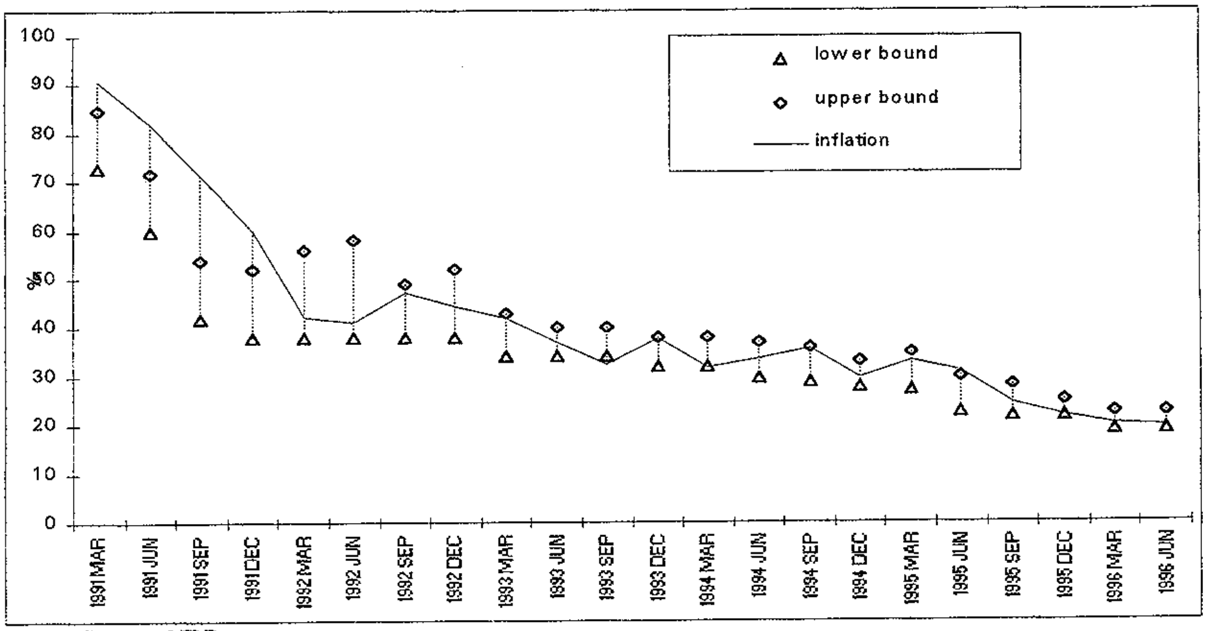
Graph 9
Structure of nonfinancial sector deposits (foreign currency deposits in zlotys at the official NBP exchange rate)



*) Three quarters of 1996.
Source: NBP.

Graph 10a

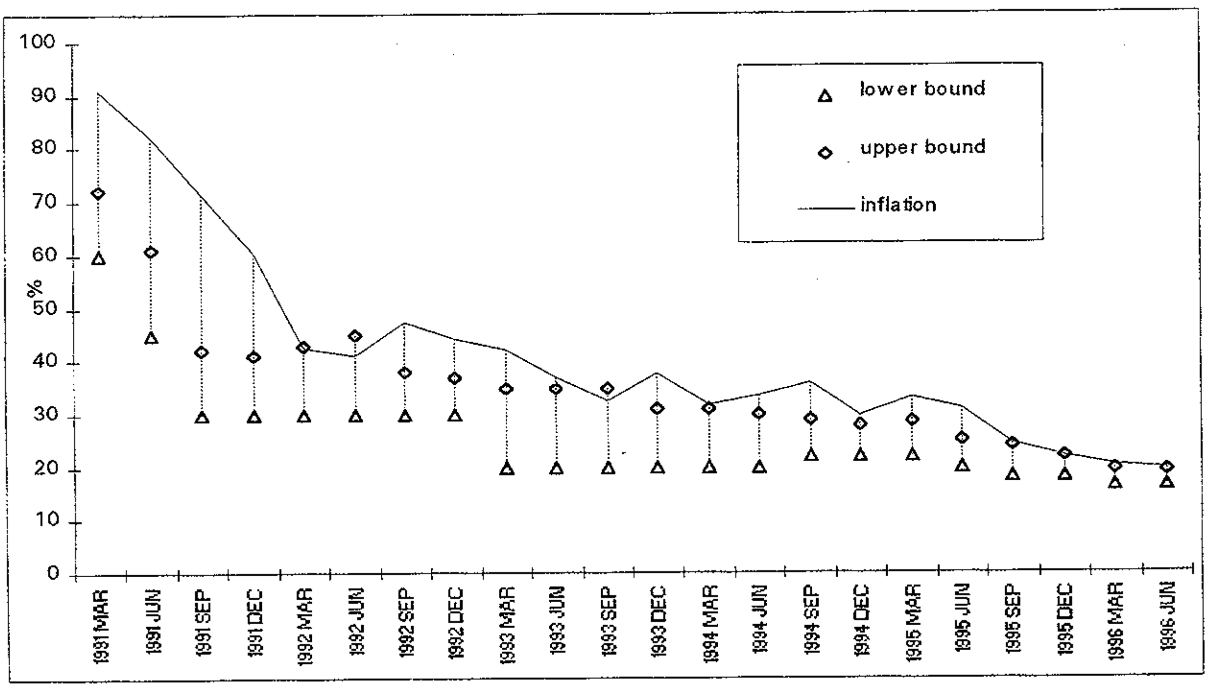
Interest rates on 12-month-deposit in major commercial banks vs. past 12 months' inflation (lower and upper bounds of interest rates in annual terms annual inflation index: end of the quarter current year to end of the quarter last year)



Source: NBP.

Graph 10b

Interest rates on 3-month deposits in major commercial banks vs. past 12 months' inflation (lower and upper bounds of interest rates in annual terms annual inflation index: end of the quarter current year to end of the quarter last year)



Source: NBP.

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DELAYED REFORMS OF THE SOCIAL POLICY

Stanisława Golinowska

1. Introduction

The Polish transformation commenced with a radical stabilisation programme in the economy and introduction of fundamental systemic changes by the Act on Economic Freedom, price freeing and privatisation was not paralleled by equally radical institutional changes in the social policy. On the contrary in two areas of social policy, viz. pension benefits, health care and education no fundamental reforms have been undertaken, whereas in the first area a clear policy of expansively prolonged exclusively state care was applied. Time and again an opinion is voiced that it was necessary due to the need to offset social effects of the radical economic programme. This argument is also interpreted from a purely political point of view, viz. it was necessary to meet the costs of legitimisation of systemic changes.

This does not, however, imply that in the social policy we deal exclusively with the continuation of old concepts and solutions. Also in this area transformations were made, sometimes of vital importance is certain specific areas. First and foremost, one should note the abandonment of subsidising prices of bare necessities of life, commencement of development of social services NGOs as well as establishing a network of social assistance organisations and labour market.

However, if we analyse the trends in the spending breakdown in Poland (see Table 1), then we have to note that the breakdown shows uneven pattern from the social growth harmony point of view. Spending on investments into human resources: family policy, education and culture are systematically reduced in favour of cash benefits for old-age and disability pensioners, the unemployed and social assistance beneficiaries. The last two categories of spending have much smaller weight compared to the first category.

How much the above trends are the effect of conscious political choice and how much the effect of inertia of emerging political procedures? It is difficult to provide a coherent answer to this question. In further part of the paper I shall try to analyse some decisions and their political impact in the selected areas of social policy.

2. Swelling expenditures on pension benefits

The main growth factor underlying pension benefits increases in the welfare states, which is ageing of societies, does not apply to Poland yet, since Poles are still relatively young society. The old-age rate does not show a growing trend yet (see Graph 1). This process will start only at the turn of the first decade of the subsequent century. Therefore, it might seem that Polish delayed demographic transformation will considerably decrease the actual burdening by the pension system. Meanwhile Poland found itself in a position much more difficult than that of many capitalistic welfare states. The systemic dependency rate is double the demographic dependency rate. On the onset of transformation the pension system was used to attain political and social goals without giving thought to long-term economic consequences and with regard to pension system the required time horizon is, at least, quarter of a century that is period of growing up one generation.

Let us remind the said social and political conditions and choices made in the first phase of transformations in Poland.

– The indexation of pension benefits that had not been made earlier in the hyperinflation environment (inflation rate in 1989 was 351%, while in 1990 — 686%) would have led to the unprecedented depreciation of benefits and consequently to extreme poverty of the elderly. The implementation of the indexation of both benefit calculation base and benefits themselves, which was guaranteed by a parliamentary bill was an extremely advantageous, but at the same time very costly, solution to the social problem of the pensioners' population.

– Relatively better economic position of the pensioners in the environment of job insecurity in many enterprises and enormous depreciation of savings prompted many people to retire earlier. It was possible thanks to liberal disability certification system and numerous possibilities to take advantage of regulations on earlier retirement due to difficult or special work conditions, or due to occupational privileges. In addition to that new regulations came into force that allowed workers to retire earlier if their company was threatened with bankruptcy. These decisions helped, to a large extent, to reduce the scale of swelling unemployment that was anyway growing in Poland very quickly. Disability pension or earlier retirement were frequently a substitute of badly-paid and insecure job in many enterprises and unemployment benefit.

– The income policy towards pensioners, quite different from income policy applied to other groups of population (see Graph 2) was motivated politically. The underlying idea was to reduce the resentment of the older population to a new system and to win the electorate with ever growing political importance. It was believed that the older generation does not have big chances to take advantage of the benefits brought by a new system such as economic freedom and market relations. Therefore, the provision of handsome income for this group of population was to offset lower chances.

– Political reasons must be also used as an explanation for the solutions adopted for the peasant population that astonish even the most competent in comparative studies foreign experts, which are after all hard to surprise. It is really hard to justify why the minimum pension and indexation of KRUS benefits are determined in relation to the average wage rather than average income in the rural sector. How to explain putting up with the existence of disability certification system that provides farmers with a wide-spread cash income leading to situation, where transfers, following income distribution, for this social group are twice as high as that for the employee group?

The lack of economic calculation what is the impact on the costs of the pension system of the politically-driven decisions quickly led to the accumulation of macro- and microeconomic problems.

Spending on pension benefits to GDP went up to almost 16% in 1995 (see Table 2), which is one of the highest shares in the world. Despite very high social security contribution paid by the employers, the pension system requires a constant subsidy from the state budget that surpasses budgetary spending on health care or education (see Table 3). A large disproportion emerged in the breakdown of public social spending.

The pension system absorbed almost 50% of the social public spending, which is today commonly felt in the form of deficit of funds for other social goals. It should be noted that the scale of disproportion in the social spending breakdown is exceptional in Poland (see Table 4).

Another macroeconomic effect of the pension system expansion is the persistence of the high inflation rate. Pension benefits as an important and wage-indexed element of the public finance hamper considerably the possibilities of bringing down the inflation, which is one of the prerequisites for full membership of Poland in the European Union (one of the Maastricht criteria). Poland has a lot to do in this area, since the inflation rate, despite permanent declining trend, is still closer to 20% than to 10%.

Maastricht Treaty requirements also pertain to the public debt level and budgetary deficit. Though Poland in both cases has ratios that are within the prescribed limits, but subsidising of social insurance system with the budgetary funds is one of the major sources of indebtedness and related costs. In 1995 the servicing costs of the domestic debt amounted to 12.2% of the budgetary expenditure, while still in 1991 they accounted for only 1.1% (Central Statistical Office (GUS), Statistical Yearbook 1996, p. 501). Interesting view from the political science perspective is that indication of the indirect taxes (VAT) as a potential financing source for both current spending on pension benefits and for passing to the funded system (Pawłowicz, RSSG November 1996). This view clearly overlooks the macroeconomic effects of financing social insurance from the growth of general tax income in the name of narrowly perceived interest of the employers (liquidation of social security contribution).

Another essential implication of the high level of pension expenditure in the macroeconomic area are relations with the labour market. As mentioned before in the first phase of transformation the increased number of the older workers retiring was driven by the unemployment threat. The restriction and imposing discipline on the early retirement eligibility criteria as well as the reform of the disability certification aims at reduction of the number of retirees given the existing difficulties on the labour markets, both national and local. However, the pressure on replacing joblessness with pension benefits is exceptionally strong in Poland, since there is an average annual influx of new labour amounting to 500-600 thousand persons that is hard to utilise despite ongoing economic growth. The high influx of new labour is a vital argument to maintain a possibility of easy retirement i.e. to maintain so far high level of labour outflow. In parallel in the political and economic government programmes an ambitious goals to reduce unemployment occurred, however they disregard the reduction of earlier retirement under the reform of the pension system (Package 2000).

Microeconomic effects of high spending on pension benefits boil down to the high contribution level excessively burdening labour costs. This problem had been pointed out earlier and with deeper understanding than the occurred disproportion in the social transfer structure. An important role played voices of employers that were given coverage by various organisations, in the past two years by the Institute for Studies on Democracy and Private Company, National Economic Chamber.

Given growing expenditures on pension benefits leading consequently to ever increasing tax and tax-like burdens of the working force the voice calling for the reform of the pension system is more and more audible.

First and foremost, there is a call for a systemic reform, which predominantly pertains to changing the way of financing the pension system (abandoning pay-as-you-go system in favour of funded system) and to increase the liability of other than state entities securing old-age income such as employers as well as to boost individual providence.

If the systemic reform is introduced in the situation where the spending on pension system reached extremely high level then the spending will be further increased by the transition costs.

The bigger the scale of passing to the funded system, the bigger deficit in the pay-as-you-go system that finances on a current basis pension benefits is bound to be. Indicating extra funds to bridge the deficit, coming predominantly from the privatisation of the state property may lead to fatal illusions. The level of the potential deficit in the pay-as-you-go system caused by the change of the financing system and potential privatisation effects is not the same in a given period. The easiest would be to increase pubic debt collateralized by the privatisation resources and then convert bonds into shares. There are many traps carried by this solution that if neglected might prove to be dangerous. These traps include the servicing costs of a new portion of a public debt, long privatisation process of allocated privatisation assets, low ability of so allocated privatisation assets to generate dividend.

The indication of the extra funds to finance the transition period undermines primarily the determination for cutting spending on the pension benefits. This fiscal aspect of the reform, unwillingly raised by the politicians, is in my opinion the key to the systemic reform. The lower the spending on the pension benefits is, the more room for setting up funded system and the lower transition costs will be, since then the contribution paid into the pension funds may be a supplementary contribution that will not deepen the deficit of the base system.

From the political point of view it is a very inconvenient conclusion. However, the responsible solution for the future may not overlook the fiscal aspect of the reform dealing with the operational principles of the base system.

The main measures under the reform of the base system should entail:

– change of the pension formula, decreasing rate of redistribution of the system, but accounting primarily for the development of the demographic processes and situation on the labour market. Such pension formulas have been recently developed in Sweden, Italy and in Latvia;

– introduction of the age elasticity enabling retirement at the 60-70 age bracket;

–liquidation (buy-out) of the pension privileges;

– curtailment of the wage-driven indexation in the wage growth environment.

Polish reform of the pension system should respect two principles, the first based upon almost 100-year-old tradition of the European social insurance system and the second being the outcome of the pending issues from the past few years.

On the one hand the insurance principle is meant here under which equivalency is crucial (i.e. reciprocal character of the contribution and benefit). On the other hand, the principle of gradual extension of the funded pillar of the system is meant, in order to avoid additional costs related to financing pension benefits at the expense of other public expenditures, increasing simultaneously future security of the system (both for younger generations and for the population having higher than average income) by diversifying ways of financing and creating additional institutions securing old-age income.

A major success factor of the reform is its timing. Further delay of the reform will result in the persistence of high level of spending on the base system and in the growth the transition costs.

Privatisation assets will be shrinking year by year, while postponing the setting up of institutions necessary to launch the overall reform will prolong the implementation of the reform programme.

3. Social inequalities and poverty

The crisis during the first phase of transformation, leaving aside the underlying reasons and its depth, caused the significant reduction of income of many social groups and drastically limited possibilities of common access to money earning through lower demand for labour. The results of the studies carried out on this problem indicate that the average decline in the real income came to a halt in 1993, while in 1994 the real growth of average wage was recorded. At the same time the analyses of the income and wage distribution indicate the persistence of high poverty rate (IPiSS, GUS) and deepening of inequalities that occurred in the first phase of transition. The poverty rate applying various criteria (poverty lines) is not declining, while the right side of the income distribution is becoming longer, which implies that the number of people with very high income is growing.

Where did the poverty on a high scale occur and does this phenomenon acquiring a permanent character?

Firstly, the regional (spatial) differentiation should be noted that is the manifestation of differences of economic development and social stabilisation of the local communities. There are regions in Poland where there are no jobs due to the absence of industry and collapse of the state farming. If on the top of that you add in some regions the lack of social integration within a community (migrant people) then the crisis situation is reinforced and cause further growth of the gap between the living standard ratios of that community and national average ratios, which is even bigger when compared with the fastest growing regions or municipalities.

An interesting result of the studies on the regional differentiation is higher activity of job seekers (commuting to work, internal migrations and migration abroad) in the regions with stabilised communities (southern and central-western Poland). I am leaving aside border areas where this type of activity, due to obvious reasons, is exceptionally high (IPiSS, VUPSV, JAB).

The poverty in some places and municipalities is a particular social threat: it consolidates the idleness through the lack of positive examples how to cope with the problem, children and the youth are growing accustomed to such situation, educational efforts are reduced (there are even instances of not sending children to school), makes people dependent from the external benefits and assistance.

Another social cross-section with vital income differences is socio-demographic cross-section. I mean here the age connected with the family development stage. The results of the studies on poverty carried out in Poland over the past few years (World Bank, IPiSS, GUS) indicate that the young people, especially in the procreation age, are threatened the most by the poverty. Numerous families with a non-working mother are, as a rule, poor families. If such families are affected by the unemployment then their position becomes dramatic. The unemployment in such families is correlated positively with the lack of qualifications, or low qualifications of parents, and frequently with alcohol problem.

For the purposes of income differentiation and poverty studies educational profile proved to be of crucial importance. Positive correlation of better income position with higher education come to the surface especially in the past 5-6 years and vice versa bad income position — with the lack of qualifications and resourcefulness.

The rate of poverty in Poland, despite the economic growth since 1993, has practically not diminished, though it stopped to grow. This can be confirmed by applying all poverty lines (see Tables 5 and 6). In addition to subjective poverty lines the hypothesis explaining the poverty rate staying on the same level talks about the permanence of difficult economic standing of many local centres, where there is no internal source of activity, while help, or external intervention will not lead to the reaction stimulating such activity. Studies on this subject (e.g. German-Polish-Czech project (IPiSS, VUPSV, JAB)) indicate that in such local centres there is a concentration of poverty generating factors: no industry or declining branches of industry, large scale of bankrupted state farms, unemployment, low educational level of the local community, numerous families and alcohol problem.

Social policy with the instruments oriented at providing assistance in such local centres allows people living there to live at the minimum of subsistence, or perhaps even more than the biological level. However, the assistance does not change their position, which becomes more and more permanent.

While evaluating such social policy we have to state that the number of active instruments on the labour market is by far too small (see Table 7). Moreover, if such instruments do appear e.g. incentives for employers in the municipalities with high structural unemployment, then it turns out that such instruments prove to be the most beneficial for places where there is already some activity rather than places whose position is the most difficult. Simply in the latter places there are no addressees of such set of instruments.

If we now consider the instruments applied currently in family and educational policies, then we will also notice that when they are applied to the poorest population are not very useful. Family benefits, though dependent on the income level in the family, cannot improve the position of children in the poorest families. It is not only because the benefits are low, but primarily because in such families such benefits are one of the primary sources of cash revenues of the whole family next to the unemployment benefit or/and social assistance allowance.

The change in the family benefits calculation from universal to means tested formula did not improve the position of poor children in Poland. Therefore, at present other instruments are under consideration. These include meal vouchers, materials for pupils, transport to school, summer camps. Generally, funds available for the mentioned purposes do not much the needs, while the competition on the part of other expenses supported by strong political argumentation puts them more and more aside.

A chance for the poorest children is to move them from the culture of poverty getting stronger and stronger. However, the trend visible among the schools to shed social and educational functions because of a lack of funds as well as the lack of the concept how a school should operate in the local environment, renders the fundamental institution of active measures passive towards local social problems. Additionally, local educational system on the non-primary level does not currently meet the needs of labour market. An opinion is frequently met that traditional vocational schools are the reason for youth unemployment and it is not far from truth.

Thus, the poverty in Poland, specifically poverty among children, that are more severely affected than other social groups, goes in hand with the lack of educational reforms, lack of family policy and predominance of passive forms in the social assistance area.

4. Institutional reform in the social policy

An important element of the planned social policy reform are institutional changes pertaining to the demonopolization of the state social service providers. On the one hand the idea was to create a number of social services offered under market principles. The process quickly gained momentum, but came to a halt within its "natural" limits determined by the demand of non-wealthy society. On the other hand an intention was to develop a voluntary non-government sector of non-profit organisations that would take over the provision of social services, delivered so far exclusively by state providers. It was hoped that the services will be more customer-oriented and thus more desired and less expensive.

Non-government non-profit sector was also developing dynamically since 1988.

At present, however, the growth came to a halt and numerous problems occurred. Tackling of these problems requires new fundamental, systemic regulations. Polish foundations and associations, despite many successes, do not enjoy a positive image in the society. The bad perception was caused by giving wide coverage to misperformance of a few public foundations. The central and local governments show reserve when dealing with foundations and the path to partnership relations seems to be a long one. At the same time NGOs need public finance. Without them their activities will acquire a marginal and self-assistance character. Self-assistance is extremely desirable, but does not imply needed benefits for the third parties.

The improvement of the image of voluntary non-profit sector and rise in credibility through creation of acceptable revision and audit procedures are at present the main objective of the reformers of the social policy in Poland. The NGOs sector is very much concerned whether drafted revision and audit procedures [1] are not going to be used to restrict the freedom of their activities. Therefore, the sector shows lack of confidence to the undertaken measures, though mainly by experts (IPiSS 1996). Other Central and Eastern European countries have arrived at similar points. The construction of new

[1] Placed in the draft Act on Public Use Activities (Izdebski 1996)

regulations follows similar paths, though the underlying philosophy varies (IPiSS conference 1996 "NGOs and governments").

In Poland an attempt is made to define the public use activity (activity-oriented approach) the running of which would give an organisation a right to apply for certain privileges (tax privileges, or a possibility to get a subsidy, tender for a central local government contract etc.). In most Central and Eastern European countries an attempt is made to create a non-profit NGO (entity-oriented approach) with clearly defined objectives and operational principles (Hungary, Bulgaria or Russia).

In all countries of the region the political interest in reforming this area is substantial. It is an area visibly undervalued by the politicians not only in economic terms — a possibility of cutting the costs of social services — but also in political terms — a possibility to improve public opinion on ongoing systemic changes. Regulations on new institutions should increase the confidence in them, both of the societies and governments.

5. Conclusions

The Polish reforms in the area of social policy require much bigger political determination needed for their designing and implementation.

The leading position in the transformation design process in Poland is the reform of the pension system. Its delay creates a lot of problems, both macro- and microeconomic in their nature. However, it represents the biggest threat to the security of old-age income provision at the level on which obligations are generated today.

The reform of the pension system is extremely difficult problem starting from the onset of the process i.e. conceptual stage. The intricacy of the problem is heavily influenced by the political character of the proposals pertaining to the reduction of existing benefits and privileges (state retrenchment).

The difficulties are further increased by the lack of consensus among the experts. In Poland the evaluation of the reform drafts is heavily influenced by the labour law workers, who in the past had monopolistic position in the area of social insurance. The lack of economic perspective led, to a large extent, to careless increases of spending on the pension benefits in the last few years. Though the importance of economists in the reform designing activities has increased, it must be noted that frequently these are economists with the field of speciality far from social insurance system, stressing in their views one-angle approach of using the reform of the pension system to pursue such goals as development of the capital market, privatisation or more generally economic growth.

The bringing of the social goal of the reform to the protection of the older generations against poverty, which following the thesis of the World Bank experts (World Bank 1994) also occurred in so called M. Mazur draft reform (Mazur 1996) was perceived in Poland as the manifestation of the ignorance on the European insurance tradition and negligence of social solutions for the middle class. However, towards the end of 1996 the consensus of the experts on the pension system reform was in much bigger number of areas than ever before[2], which would allow to make a big step forward in the reform of the pension system. Unexpected death of a highly competent Andrzej Bączkowski, Minister of Labour and political calendar for 1997 might prolong the design stage of the reform.

The educational reform, regional and labour market policies oriented at active forms combating poverty and lack of activity also require political attention and reorientation. Particular threat to the future is represented by the delays in reforming the areas of education and training.

Initiatives on the local level and independent solving of social problems have their limitations and frequently do not raise confidence as being illegitimate and hardly professional. The reforms supporting voluntary organisations requires special attention when large, complex reforms are being delayed. This would allow to fill in the institutional vacuum in the social policy area and to reduce chaos.

All in all, another stage of economic reform in Poland requires a great deal of transformations in the social area, embarking on the path of systemic reform crucial for the systemic transformations and social goals in the future.

[2] It was thanks to numerous discussions and publications of IPiSS, Club 500, Case Foundation and World Bank.

Tables and graphs

Table 1

Size and breakdown of public (central and local governments') social spending in Poland in 1992-1995

	1992	1993	1994	1995
Social spending				
a) in zł (m)	40,003.6	52,529.6	74,384.0	
b) in %	100.0	100.0	100.0	100.0
c) % GDP	34.8	33.7	35.4	
– pension system				
a) in zł (m)	16,783.8	23,194.1	33,229.8	44,368.6
b) in %	42.9	44.2	44.7	
c) % GDP	14.6	14.9	15.8	15.5
– family benefits				
a) in zł (m)	2,869.9	2,909.0	3,084.3	2,949.6
b) in %				
c) % GDP	2.5	1.9	1.5	1.0
– education (including higher education)				
a) in zł (m)	6,243.9	8,367.6	13,123.7	17,700.7
b) in %	15.6	15.9	17.6	
c) % GDP	5.3	5.3	6.2	6.2
– health care				
a) in zł (m)	6,138.1	7,735.3	10,812.9	14,642.4
b) in %	15.3	14.7	14.5	
c) % GDP	5.3	5.0	5.1	5.1
– labour Fund spending				
a) in zł (m)	2,467.6	3,190.3	4,346.3	6,483.2
b) in %	6.2	6.1	5.8	
c) % GDP	2.1	2.0	2.1	2.3
– social assistance				
a) in zł (m)	1,727.3	2,337.9	3,231.3	6,774.3
b) in %	4.3	4.5	4.3	
c) % GDP	1.5	1.5	1.5	2.3
– culture and recreation				
a) in zł (m)	703.9	934.9	1,334.0	1,814.1
b) in %				
c) % GDP	0.6	0.6	0.6	0.6
– price subsidies*				
a) in zł (m)	1,312.3	1,018.8	998.6	979.6
b) in %	3.3	1.9	1.3	
c) % GDP	1.1	0.6	0.5	0.3

* Price subsidies include subsidies to: food, coal, public transport, housing maintenance, advances to cars.

Source: own calculations and estimates based on GUS, ZUS, KRUS and Ministry of Labour and Social Policy data.

Table 2

Share of expenditure on pension benefits in GDP in the East and Central European countries

Country	1989	1990	1991	1992	1993	1994	1995
Czech Republic	8.3	8.0	7.8	8.4	8.4	8.4	9.0
Slovak Republic	7.7	7.8	8.5	9.1	9.6	9.3	8.3
Hungary	9.1	9.0	10.6	11.2	11.3	11.5	-
Poland	8.2	8.1	12.2	14.7	14.9	15.8	15.5
Romania	5.7	7.2	7.0	6.4	-	-	
Bulgaria	8.7	8.7	9.4	10.2	9.5	9.4	-
Russia	5.9	6.0	6.6	4.0	5.9	-	-
Ukraine	4.4	4.9	6.9	7.1	7.7	11.1	-
Belorussia	-	6.2	6.4	5.7	6.0	-	-
Latvia	6.3	5.8	7.8	6.2	9.6	9.8	10.3
Lithuania	4.9	5.5	6.1	5.8	5.1	6.9	7.4
Estonia	-	-	-	5.3	6.6	6.5	7.0
Albania	5.7	6.8	10.1	6.2	6.2	-	-

Source: materials collected from the listed countries and IPiSS data.

Table 3

Subsidies from the state budget to pension benefits (million zlotys)

Type of subsidy	1991	1992	1993	1994	1995
Subsidy to employee scheme, of which:	2,206.0	4,950.8	6,605.2	8,296.9	6,000.0*
earmarked	997.5	1,598.7	1,657.0	2,395.2	1,822.2
compensatory	1,208.5	3,352.1	4,876.2	5,901.7	4,177.2
Subsidy to ZUS used for writing-off companies' debts				800.0	916.2
Subsidy to farmers' scheme	1,362.1	2,247.3	3,085.0	4,721.6	6,101.6
Share of subsidies in GDP (%)		6.3	6.2	6.6	4.6

* Reduction of subsidy to the employee scheme in 1995 is due to, among others, non-reducing social security contribution, while the family benefits financed so far from the contributions, from March 1995 have been financed from general taxation (state budget) and to no indexation of benefits in IV quarter, which has to be made in 1996 under the Constitutional Tribunal decision.

Source: GUS, ZUS and KRUS data.

Table 4

Breakdown of social expenditures in 1993-1994 in the East and Central European countries

Country	Education	Health	Social assistance and expenditures on unemployment compensation	Pensions	Family benefits**	Price subsidies
Czech Republic*	16.5	32.5	2.0	32.5	-	0.0
Slovak Republic	19.6	18.1	5.0	36.2	10.4	5.8
Hungary	18.8	14.4	10.2	33.2	12.7	4.8
Poland*	17.6	14.5	10.1	44.7	1.5	1.3
Albania	19.7	17.7	5.9	30.5	1.0	10.8
Bulgaria*	21.4	18.6	13.9	43.7	7.4	-
Romania	20.9	18.4	-	39.3	-	-
Estonia	29.5	22.8	2.5	-	8.4	-
Lithuania	24.4	15.5	2.0	38.9	7.6	-
Latvia*	30.3	20.2	6.2	35.7	6.2	4.7
Belorussia*	29.5	21.0	0.6	34.7	11.0	-
Russia	-	-	-	-	-	13.6
Ukraine*	21.0	18.5	-	33.5	-	14.0

* For countries marked with asterisk data from 1994, otherwise from 1993.

** Family and maternity benefits.

Table 5
Poverty incidence in 1989-1992 (average in %)

Poverty lines	Individuals	Households
40% of the average wage in 1989 (ICDC, UNICEF)		
1989	24.1	22.3
1990	40.7	34.2
1991	37.9	30.6
1992	36.3	29.6
60% as above (40% of the average wage in 1989) (ICDC, UNICEF)		
1989	5.8	4.8
1990	9.7	6.4
1991	8.4	5.4
1992	10.9	7.2
Subjective		
- according to SPL method (applied by J. Podgórski)		
1989 September		17.4* 26.1**
1990 (May)		32.6
1992 (IV Qtr - *Leydon Poverty Line*)		35.5
- according to surveys by L. Beskid - opinions of household heads		
1989 (October)	29.0	
1991 (June)[a]	41.0	
Social Minimum		
1989	14.8	
1990	31.2	
1991	32.6	
1992	32.4	
	b	c
Relation of the social minimum to the average income		
1989	43.8	57.8
1990	56.0	81.1
1991	57.8	88.8
1992	63.4	85.6

* Employee households.
** Old-age and disability pensioners.
[a] Persons from urban households.
[b] Based on data on population income from the national accounts (macro-perspective).
[c] Based on the average income from studies of family budgets.
Source: research ICDS UNICEF (1995), the IPiSS, the GUS (1994), the IFiS PAN (1989, 1991), Golinowska (ed.) (1996).

Table 6
Poverty rate in 1993-1995

Poverty lines	Value of the applications of the poverty lines	Poverty rate (in %)		Number of poor persons (in million)
		Individuals	Households	
Subsistence minimum 1994	102.5	6.4		2.5
$ 120 per capita PPP from 1990				
1993 (Milanovic)		26.0[a] / 19.0[b]		9.9/7.4
Relative lines:				
- 50% of equivalent household expenses (OECD scale)				
1993	127.3	12.0	9.0	
1994	135.4	13.5	10.1	5.2
1995		12.8		
- 60% of equivalent household expenses (OECD scale)				
1994	162.4	24.3	18.9	9.3
- minimum old-age pension				
1993 (35% of average wage)	123.1	14.4	26.2	5.5
1994 (39% of average wage)	153.9	20.9	16.0	7.0
1995		18.5		
Subjective lines				
- LPL				
1993 IV Qtr.			40.0	
1994 II Qtr.		33.0	39.3	12.0
1995 II Qtr.			45.0	
- surveys conducted by L. Beskid				
1993 (March CBOS)		41.0		
1995 (January)		47.0		
Social minimum				
1993	165.0	34.8	28.0[d]	13.4
1994	218.0	54.0 / 43.2[c]		16.6[c]
1995		53.0		

[a] From a household budget data.
[b] According to income macro.
[c] According to the modified bundle.
[d] According to the line specified for a four-person wage-earning household.
Source: research conducted by the IPiSS, the GUS and the World Bank (1995), Milanovic (1995), the CBOS (1993), SOCO (1995), Golinowska (ed.) (1996).

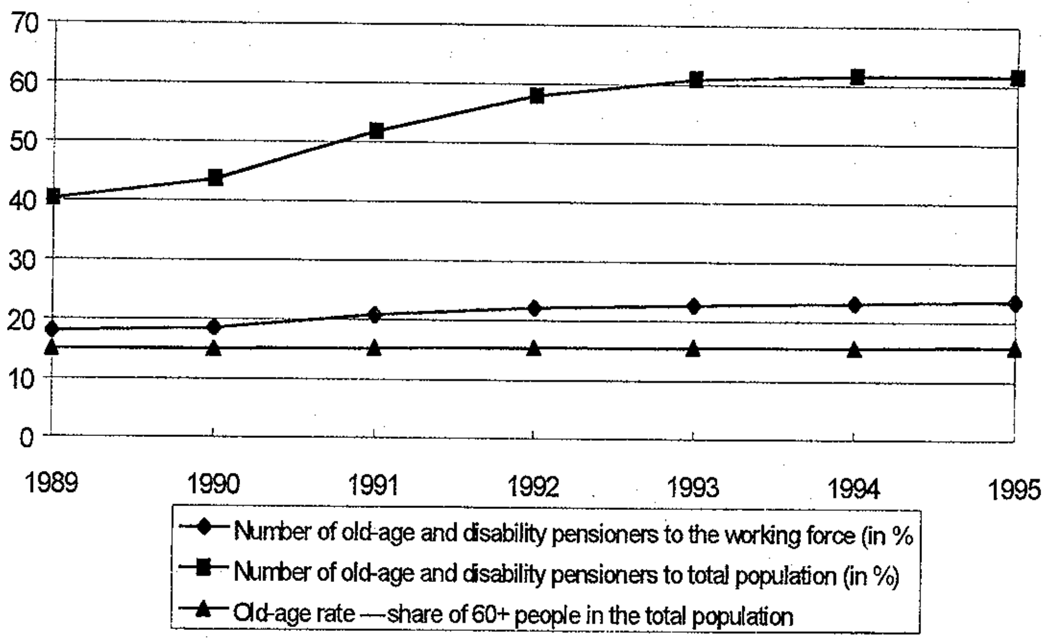
Table 7
Structure Labour Fund's expense in 1990-1995 (in %)

Item	1990	1991	1992	1993	1994	1995
Unemployment benefits	51.1	82.0	86.3	83.9	83.8	84.8
Active forms, of which:	31.1	7.0	4.7	11.1	12.8	11.9
– vocational training	0.4	0.7	0.8	1.4	1.3	8.5
– subsidised works	5.7	3.3	2.1	4.3	5.5	4.9
– public works			0.8	3.7	4.7	4.0
– loans	26.0	3.0	1.0	1.7	1.2	1.0

Source: data of the Ministry of Labour and Social Policy.

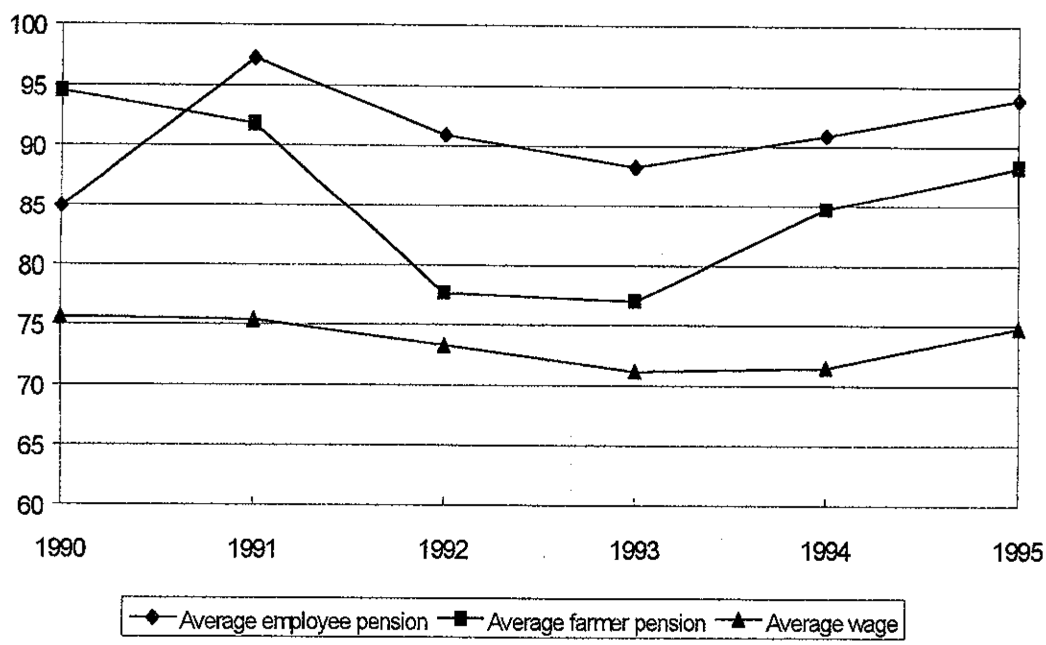
Graph 1

Number of old-age and disability pensioners and the elderly to total population and working force in 1989-1995



Graph 2

Real old-age and disability pensions in 1990-1995



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PRIVATIZATION IN POLAND. ACCOMPLISHMENTS, DELAYS AND THINGS TO DO[1]

Barbara Błaszczyk

1. Introduction

1.1. Privatization dilemmas and the attempts to resolve them

At the beginning of the reform process in Poland, the expectations concerning privatization were enormous. Privatization was expected to increase economic efficiency, both for privatized companies and for the economy as a whole, to create a capital market, to relieve the burden on the state budget, even to reduce the foreign debt, and at the same time widen the private ownership of economic assets among the population.[2] It was not immediately evident to all the Polish reformers that some of those privatization goals were partly contradictory and could not be achieved simultaneously.[3] Secondly, among the population there was a popular belief in the very high value of the state owned assets. Last but not least, there was no awareness among the reformers how strong the resistance against privatization in some groups of the population would be.

Now, six years after launching the privatization process we are more aware of the hierarchy of goals that can be achieved through privatization and of the political economy of privatization[4]. It became clear that the first and most important goal which should and can be achieved is the increase of economic efficiency and competitiveness of privatized enterprises. The intention to maximize this goal is to some extent in conflict with maximizing budgetary revenue from privatization[5]. The second

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[1] The first part of this paper was presented in its first version under the title "Privatization Successes and Failures" at the Conference on "Ownership Transformation and Restructuring Processes in Central and Eastern Europe" organized by the Center of Social and Economic Research CASE on 11-12 April 1996 in Warsaw and supported by the Committee of Scientific Research (Komitet Badań Naukowych) and the PHARE ACE Program 1995. The Author is grateful to the participants for their valuable comments. The author is also grateful to Małgorzata Antczak for her help in preparation of the statistical material and to Richard Woodward for his editorial work.

[2] See Ministerstwo Przekształceń Własnościowych (1991).

[3] For instance, it is impossible to gain high revenues from privatization for the state budget and to maintain a rapid speed of ownership transformation. It is also not possible to simultaneously satisfy the state budget with high revenues and the citizens through a wide diffusion of private ownership. Moreover, there is a choice for the government between the achievement of high budgetary revenues from investors for sold companies or allowing to invest a larger part of this money direct into these companies. A more general discussion on this topic was presented by the author in: *"Institutional Approaches to Privatization and Post-privatization Problems"*, paper presented at the Fourth Conference of the EACES in Grenoble, 12-14 September 1996 on *Institutional Changes and Problems of Economic Adjustment.* A revised and expanded version of the paper will be published in the book *"Seven Years of Privatization in Post-Communist Europe: An Assessment"*, ed. by B. Błaszczyk and R. Woodward, CASE, Warsaw, forthcoming.

[4] An interesting and new approach to analyze the political economy of privatization in Poland is given in: Jan Macieja, *Why do politicians resist privatization?*, "Rzeczpospolita", forthcoming.

[5] A recent example of this conflict of goals is given in a text written by the director of a large power company being prepared for privatization. The author shows that the maximization of budgetery receipts received from selling shares of this company to a foreign strategic investor will diminish the value of his direct investment

goal — to increase the economic efficiency of the economy as a whole and to promote growth through establishing a sound ownership structure of the economy (with dominant private sector) proved to be equally important. We have evidence that the private sector became the main source of growth in our country. This finding should encourage us to speed up privatization as fast as possible. But this acceleration could be in conflict with maintaining the quality of privatization plans for individual enterprises (see goal number one) and with the good quality and reliability of the capital market. A well regulated, transparent and efficient capital market is one of the most important factors of the future investment decisions and of the allocational efficiency of the economy. Obviously, rapid privatization is also in conflict with large budgetary revenue from sales of state enterprises.

Other expectations concerning privatization, arising from the need of compensation of some social groups (restitution), the goal of a wider private ownership of assets among the population or involvement of employees in the privatization of their enterprises, should be treated rather as secondary goals in order not to adversely affect the pace of ownership transformation and to lose the efficiency effects mentioned above. However, the fulfillment of those expectations, if accomplished on a reasonable scale, can be very helpful for paving the way for privatization and breaking the political resistance against it.

Now it is clear that a well balanced compromise between different goals of privatization has to be formulated. It should include economic as well as political considerations. Unfortunately, in Poland, privatization was a very controversial political topic at the beginning of reforms and continues to be so to this day, so that it has been very difficult to reach agreement on the privatization strategy.

Social mistrust of privatization arose from different reasons: First of all, there was a typical social fear of radical changes linked with resentments of a historical nature. The employees were anxious about losing their working places and broad parts of the population often expressed fears of "selling out" enterprises to foreigners.[6] Secondly, there were some bad examples of asset stripping by the new-old owners (the so called "nomenclature"). Last but not least, influential groups of the population were interested in keeping the state-owned sector unchanged and felt threatened by privatization. To these groups belonged first of all the leaders of different former privileged industrial lobbies, from industries that proved to be completely inefficient after the liberalization of the market and which resisted necessary changes[7]. These interest groups have found strong political support in the work forces of the largest industrial enterprises which had no chance to survive without deep and painful restructuring. Immediately after the transition shock these groups became weaker and some measures which were beneficial for the whole economy could be undertaken against their will. But their consolidation occurred very fast and they have found new ways of resisting fast and radical privatization. The politicians could not play against these groups without losing large parts of their constituency. On the other hand they were unable to convince the population (as consumers and tax payers) that privatization of state enterprises was beneficial for the majority of them and would hurt only minority groups which could be compensated in other ways than keeping their enterprises alive at the cost of the remaining population.

We should add here that, at the beginning of reforms, even for those who generally supported privatization as one of the most important transition tasks, it was not sufficiently clear how deep the economic and social reconstruction (in addition to ownership change) in existing enterprises must be, how many enterprises would have to disappear from the stage, how serious the necessary structural changes in the whole economy were, and how strong the educational effort to be undertaken in order to achieve the positive effects of transition would have to be. The lack of this awareness among both the public and the politicians seems to have been one of the most important mental limitations at that time.

Other limitations of an economic, technical or organizational nature, such as the lack of domestic capital and the appropriate financial, legal and institutional infrastructure for investments, the lack of know-how and modern managerial skills and the low availability of foreign investment were equally important for an efficient privatization process but, in our view, their impact was

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and probably result in higher prices of electricity for the consumers in future. See *Elektrociepłownia "Kraków" SA*, text written by Jacek Dreżewski, "Rzeczpospolita" from 19 December 1996, "Dodatek Reklamowy Elektroenergetyka", p.XI.

[6] Moreover, in many cases an open hostility against foreign capital investment was expressed. See comparative opinion polls on the attitude toward foreign investments in Poland and Russia in summer 1992, CBOS, October 1992. See also Błaszczyk and Dąbrowski (1994).

[7] See Jan Macieja, op.cit.

smaller. In short, the knowledge of the different limitations of the reforms, and especially the awareness of who is for and against such structural reforms as privatization and why, combined with good communication skills, are of crucial importance for the efficiency of these reforms.

One should also add, that, for a better understanding of achievements and figures presented below, a clear differentiation between the *privatization of the economy* and the *privatization of the state sector* has to be made. The first means the growth of the share of the private sector in the economy and the latter the shift of assets and services from the former state-owned or public sector to private hands. The privatization of the economy, as the Polish example shows, is not necessarily achieved only through the privatization of the state sector but also through such processes as the spontaneous development of the new private sector.

1.2. Privatization concepts and legal framework

A first general debate on the privatization concept took place in late 1989 and in 1990. Three main concepts[8] of privatization came up against each other[9]:

– a commercial concept of the sale of state-owned assets with classical means, first of all through public offers, based on the British experience;

– nonequivalent privatization, based on employee ownership and on American ESOP concepts;

– nonequivalent privatization through free distribution of assets among all citizens, based on new drafted mass privatization concepts (so-called "citizens' privatization")[10].

In its first program of October 1989, the government gave preference to the first, classical, concept of privatization aiming at a sound development of the capital market and a careful step by step privatization. As a response to this commercial approach, the idea of non-equivalent privatization in its two versions was strongly promoted by different political forces. Thus, the privatization law, passed 13 July, 1990, with a half-year delay in comparison to other systemic changes, tried to find a compromise between the three concepts. Still giving priority to privatization through sale of assets (because of expected budgetary revenues), it established strong privileges for employees[11] and gave future prospects for the mass privatization, for all citizens. Different from other countries, the law has not decided on any kind of restitution for former owners.

The governmental privatization programs were rather optimistic in assuming that approximately half of the state-owned assets would be transferred into private hands within the first three years of the reform.[12]

A group of six large enterprises was privatized by the end of 1990 through initial public offerings. The so called *capital* privatization (through public offer and trade sale) got under way on a much larger scale in 1991 but continued to be carried out on a case-by-case method, which resulted in slow progress. The direct privatization of smaller enterprises through employee — management leasing, proved to be faster and more time efficient. The mass privatization program (subsequently called the National Investment Funds Program or the NIF Program), drafted for the acceleration of privatization, could not be launched until the end of 1995, although its first version was prepared in the summer of 1991 and the relevant legislation was passed in April 1993. In the first half of 1997, the NIF program will enter its more advanced stage, with the funds' shares being traded on the Stock Exchange.

[8] The fourth, less known concept was based on privatization through the establishment of holdings. This proposal was promoted by M. Święcicki and others but it hasn't found broader support in Poland. Details can be find in the book quoted in the next footnote.

[9] For a detailed description of this debate and of the main privatization concepts in Poland see Błaszczyk and Dąbrowski (1994) and Błaszczyk (1995).

[10] The first proposal for mass privatization was presented in Poland by Janusz Lewandowski and Jan Szomburg already in November 1988.

[11] In cases of capital privatization employees had the right to purchase up to 20% of the company's shares at a preferred price. In the case of direct privatization, when employees were ready to take over their enterprises using a lease procedure, they had priority and did not need to bid against other competitors. In all cases, the privatization initiative belonged to the employees and enterprise managers and their were able to block other privatization proposals.

[12] According to the first privatization program (announced in November 1990), privatization was to contribute to a 15% decrease in state-owned assets in 1991 and to an annual decrease of 20% in the following three years. As a result, in four years' time, the ownership structure of the Polish economy was expected to became similar to other market economies. See *Podstawowe kierunki*.

In 1993, two other laws important for privatization were passed: the first was the law on the restructuring of enterprises and banks, which allowed banks to start composition agreement procedures for indebted enterprises and to change their debts into equity; the second was the law on enterprises of special importance to the state, which excluded a group of enterprises from the general privatization rules.

In the summer of 1996, after long-lasting controversies, the new privatization law was passed, which, on the one hand, gave more privileges to relevant employees in acquiring free shares in the privatized enterprises[13] and, on the other, allowed new exemptions from the general privatization rules for indebted enterprises or enterprises not scheduled for fast privatization. It also narrowed the group of enterprises available for so-called direct privatization methods[14], including employee and management buy-outs. The new law, by itself, is in our view not likely to change the privatization practice in any dramatic way. However, on 1 October, 1996, implementation of the reform of the central government administration began, which included important changes in the institutional order in the area of privatization. A new Ministry of the Treasury has been established, which has assumed the responsibilities of the former Ministry of Privatization. The new Ministry will be responsible for the supervision of all state-owned assets and only one of its functions will be privatization. The privatization process of large enterprises will be carried out by the Agency for Privatization, a state corporation subordinated to the Treasury Ministry. This Agency is expected to start its work on 1 January, 1997, though its competencies are not yet clear. Smaller enterprises will be privatized by the local governments (voivods) by the use of direct privatization methods. From the latter change a more efficient privatization may be expected, arising from the future decentralization of privatization. But, on the other hand there are many fears that the simultaneous changes in the institutions and in the privatization law, but which have been launched independently and without the necessary synchronization, will cause difficulties and a further delay in the privatization process.

2. Accomplishments

2.1. Privatization tracks and their results

2.1.1. Greenfield privatization

Greenfield privatization, which occurs through the start-up of new firms, has proved to be especially important: the "bottom-up" development of the private sector has thus far been the most dynamic phenomenon in the sphere of ownership transformation of the Polish economy. As presented in the next section, this sector also had the most dynamic development with respect to production, sales, and investment. Thanks to this, a large number of new jobs have been created, allowing for the avoidance of a level of unemployment which would otherwise have been much higher than the current one. The resultant increasing numbers of enterprises in the private sector in the years between 1991 and 1995, are shown in Table 1. The table also illustrates the shifts between the private and public sectors measured by the number of economic units existing within these sectors.

In the private sector, most impressive was the growth of joint-ventures and domestic companies. The number of businesses owned by individuals doubled and reached 1.6 million. The easy start of many small private businesses was possible because of liberal entry and trade regulations, but also because of the possibility to purchase assets from the contracting state sector at very reasonable prices. The sellers were either state-owned enterprises or their liquidators. Thus, for the rebirth of the private sector, not only are the methods of privatization important, but also the decentralized opportunities to get rid of abundant assets by the state-owned enterprises.

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[13] Up to 15% of enterprise' shares can be aquired free by the employees. Another 15% can be aquired by farmers and fishermans being stable suppliers of the company.The shares aquired for free by employees and suppliers are not tradable during two years after their purchase and those aquired by the management are blocked even for three years. These terms can be prolonged in some cases even for more years by a government decision, according to the new law.

[14] According to the new law, enterprises employing not more than 500 people, having yearly sales up to 6 millions ECU and possesing own funds at the value up to 2 mln ECU can be privatized by the direct methods.

2.1.2. Small privatization

The so called "small privatization" of the retail, catering and service sectors, belongs to the most successful parts of the ownership transformation in Poland. This process was completed during the three years 1990-1992, and resulted in privatization of about 97% of all retail shops, outlets, restaurants and small service shops.[15]

There was no special government program or law on small privatization. Instead of this, the government concentrated on the transfer of the real estate on which these businesses had been operating. A restoration of the ownership rights of local governments and housing cooperatives to this real estate, resulted in breaking contracts with state retail trade organizations and establishing new contracts with private users, mostly former employees of the local units. Thus, the prevailing form of ownership transfer of retail and crafts premises and industrial objects was through rent. As a consequence of the small scale privatization, more than 90% of the people employed in domestic trade were working in private enterprises by the end of 1992, and more than 94% by the end of 1995. The number of private shops doubled during the years from 1990 to 1995 (from 223,113 to 419,313), and the sales of these shops increased almost tenfold (from 16,926.0 million PZL to 157,025.5 million)[16]. Small communal premises and units are, to a large extent, now in private hands but, in most cases, the real estate is still owned by the local authorities. There was a similar trend in wholesale trade, where the sales in the private sector increased almost seventeenfold (from 10,477 million PLZ in 1991 to 176,555 million in 1995)[17]. The number of retail shops in the public sector decreased twofold during the years 1990 to 1995 but their sale increased by more than 25%.[18] More detailed information is given in Table 2.

2.1.3. The Privatization of the State Sector. General Overview

The privatization of the former state sector has been conducted on three main tracks:

– the so called **capital (or indirect) privatization**, i.e. the sale of companies' shares preceded by their transformation into state treasury companies (so called commercialization);

– the **mass privatization program** (NIF program), preceded by commercialization;

– **direct privatization** (through **liquidation** under the **privatization law**).

These tracks have been supplemented by the **liquidation under the state enterprise law**, for enterprises which were in a weak financial state, by insolvency procedures of state owned enterprises and by bank composition procedures. The agricultural enterprises have been privatized on a different track, under a special law.

The foreign acquisitions have occurred mainly in a capital type of privatization, but additionally in direct privatization.

Table 3 illustrates the number of enterprises that entered the transformation process from 1990 until the first half of 1996, together with the number of completed privatization cases. Only 168 capital privatizations have been completed from the 1,188 enterprises transformed into commercial companies of the state treasury. A further 512 companies have been transferred to the NIF program but their privatization will take some years yet. Of the remaining 508 commercial companies 353 were prepared for individual capital privatization and the remaining 155 belong to a group for which special privatization procedures are foreseen. In the direct privatization road, almost all the projects started have been completed (1,114 out of 1,167), but in the liquidation procedure, less than one third of transformations begun, could have been completed. Altogether, the ownership transformation process for 6,015 state enterprises out of the 8,441 in this group had been started in December 1990 (71.2%), only 1,719 enterprises were completed, that is 20.4% of the total.

Table 4 and Graph 1 show the number of enterprises involved in the different tracks of the privatization process broken down into the main sectors of the economy during the years between 1990 and 1995. We can see that the majority of these enterprises were located in industry and construction and much smaller groups in trade, agriculture, transport and communications. The relative importance of ownership transformation for the industrial sector was as far much higher than for all other sectors of the economy.

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[15] See Earle et al. (1994).

[16] Current prices.

[17] Current prices.

[18] GUS, *Mały rocznik statystyczny*, 1996, p. 332.

The people employed in enterprises having initiated the privatization process[19] (Table 6), accounted for almost 10 % of the total employed in the economy and for more than 30% of industrial employment. However, one should be very careful in assessing the entire commercialization process as ownership transformation started. There is evidence that at least 400 state treasury companies have only been formally transformed without any other moves toward privatization. The entire 155 companies transformed under the law on transformation of enterprises of special importance to the economy belongs to this group, together with some 200 -250 large companies from other sectors.[20]

If we look closer at the branches of industry, where the enterprises that entered the transformation process prevail (illustrated in Table 5 and Graph 2), we can see that manufacturing clearly dominates over two other sectors: mining and quarrying, and electricity, water and gas supply.[21] As we also confirm in the section below, comparing the employment data, the huge infrastructural enterprises located in the branches of electricity, water and gas supply and in transport and communication are, to a large extent, excluded from ownership transformations.

2.1.3.1. Capital privatization

Within the so called "capital" or indirect privatization, up to June 1986, only 168 cases out of the 1,188 enterprises transformed into joint stock companies had been completed (14.1%). Among them 28 were privatized through initial public offerings and their shares are traded on the Warsaw Stock Exchange. The direct sale of shares of privatized companies to individual investors (foreign or domestic), was generally more prevalent than privatization through initial public offerings.[22] In 13 cases, a mixed privatization scheme was used which combined private sale and public offerings. Because of the limited capital resources of potential Polish investors, more than a half of the capital privatization projects were executed with the engagement of foreign capital.

Referring to the sectoral structure of companies privatized by the capital method, one should say that the vast majority (83%) of companies privatized in this way as of December 1995, were located in the manufacturing sector followed by the construction sector (Table 7). Within the manufacturing sector, the most popular branches for capital privatization were food and beverages production, the chemical industry, the electrical and general machinery industry and wearing apparel. After the last privatizations at the end of 1995 and the beginning of 1996, one can add the tobacco industry to this list.

An important new element of capital privatization, started in 1993, was the privatization of four large state-owned banks using different combinations of sale methods (Wielkopolski Bank Kredytowy, Bank Śląski, Bank Przemysłowo-Handlowy and Bank Gdański). The state treasury, however, holds majority stock in these banks. Other large commercial banks are still waiting for the "green light" for privatization and four of them were very recently merged by the state owner into one larger group within the framework of the so called bank consolidation.

Trying to assess the effects of the capital privatization track, one has to admit that from the quantity point of view, it applied only to a small number of former state-owned enterprises. One should remember, however, that these enterprises are much bigger than others, employ more people and represent an important part of the former state-owned sector. The sale of shares of these enterprises also facilitated the establishment and development of the capital market in Poland and was

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[19] The sample of enterprises having initiated privatization includes companies privatized by the capital method, companies partially or wholly owned by the State Treasury (including corporatized state enterprises designated for capital privatization, mass privatization or restructuring), and enterprises which have initiated or completed liquidation procedures under the privatization law, the state enterprise law or the law on agricultural property of the State Treasury.

[20] See Błaszczyk (forthcoming).

[21] One should add, however, that a smaller number of enterprises exists in these branches than in the manufacturing sector and that enterprises in these areas are usually larger. For example, in the manufacturing sector, besides the 1,644 enterprises in transition, there was a group of 1,619 state enterprises which had not been transformed. In the mining sector, 76 enterprises remained without started ownership transformation besides 115 transformed and in electricity, water and gas supply 75 enterprises remain untransformed along with 62 transformed. In transport and communications, 412 enterprises remain without any ownership changes and only 216 have been transformed. See GUS, *Prywatyzacja przedsiębiorstw państwowych*, 1995, p. 94-95.

[22] Direct sale of shares occurred in 150 cases, among them, in 69 cases, there was a domestic buyer, in 68 cases, a foreign investor, and in 13 cases, a foreign-domestic joint-venture. See MPW, "Dynamika", no. 29, p. 16.

the main source of income for the state budget from privatization.[23] From the quality point of view, one should add that most enterprises privatized on the capital route, especially through foreign equity investment, show very good economic performance and in many of them, an in-depth restructuring process has been launched.[24] Therefore, this group of enterprises may be treated as the pioneers in the new privatized sector. The main hindrances in capital privatization, were the very centralized administrative privatization procedure and the high politicization of the whole process.

There is still a large potential number of enterprises and companies, that could be privatized by the capital method of privatization. For some of them privatization plans had been prepared for 1996 but because of political or other reasons, these privatizations have been delayed. One may mention here at the top of the list, the copper giant KGHM Polska Miedź, the Polish Airlines LOT, the Polish Shipping Lines Polska Żegluga Bałtycka, the largest tourist company Orbis, the largest Polish department store chain Domy Towarowe Centrum and the largest press distributor Ruch[25]. There is still a significant number of potential objects for privatization in the chemical, machinery and metal industries. The next "in line", without any agreed privatization policy so far, are the infrastructural monopolies such as Nafta Polska (Fuel production and distribution), Telekomunikacja Polska, PGNiG (Polish Gas and Oil), PSE (Polish Power Grid Company) and others, not to mention railways, postal services, coal mining, sea-and airports, water supply etc. which are not considered for fast privatization.

This is a typical feature of the top-down privatization policy in Poland, that infrastructural sectors and other industrial sectors which most urgently need large investments have, so far, been completely excluded from privatization and to a large extent, from competition as well[26]. It is obvious that privatization projects in the infrastructural sectors are very expensive and complex and need a long preparation, often including the establishment of new regulatory rules. But just because of it a fast political decision on the strategies to adopt in these sectors is needed. It is important to stress here that, in the author's view, the main barriers that hinder a faster and more even privatization in our country originate from the political considerations of the government resulting from pressure by interested groups blocking privatization.

There are other reasons, as for instance, the lack of agreement regarding the scope and methods of the use of state-owned assets for possible structural reform, for example the social security and pension reform, and for compensation of different social claims. The privatization ministry reported already a year ago that it is not able to push faster forward the capital privatization without having a clear message from the government, what shape the expected social security reforms will have and what proportion of assets to be privatized should be used for these reforms. But until now, the governing coalition was unable to make decisions in this field, because of political reasons.

2.1.3.2. Foreign investments

Foreign direct and equity investments should be mentioned here as a special category. Foreign investors in Poland may use several ways to set up business. The first possibility is to establish a joint venture with a Polish private or state-owned company. The second is to purchase a majority stock or portfolio investment in privatized or private companies, and the third is a green field investment. All these possibilities are used by foreign investors.

Foreign investments, a natural source for modern know-how and management, were hard available at the beginning of the transition process because of the high risk to investors arising from the high inflation, the tremendous foreign debt, poor performance of many enterprises after the stabilization shock, the unpredictable results of the reforms and the unfriendly attitude to foreign investors demonstrated by parts of the population and some politicians. This situation changed gradually, especially after 1993, when the Polish economy started to rise quickly. This encouraged foreign investors to start their activities to a larger scale in Poland. On the other hand, the general

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[23] See Table 5.

[24] Dąbrowski (1995), and Błaszczyk (1994).

[25] Other delayed cases, planned for 1996 are: household producer Polar, Paper factory Celuloza Świecie, fertilizer producer Puławy and foreign trade holding Impexmetal.

[26] A new counterproductive direction in this field is the attempt to establish new state-owned monopolies in the infrastructural sectors. The first example is Nafta Polska, a holding established in 1996 through a merger of all state enterprises from the petrochemical industry and dealing with oil distribution.

atmosphere for foreign investments changed in a more positive direction. All this resulted in a fast development of foreign investments in Poland.

At the end of 1995, some 24,000 enterprises with foreign investment were active in Poland but only in some 362 of them was the value of foreign equity higher than US 1 million.[27] The entire value of large foreign investments was US 6.8 billion at that time and additional investment commitments have been valued at US 5.2 billion. The value of smaller investments (lower than US 1 million) was estimated at US 1.8 billion. Altogether, the value of the invested capital was US 8.5 billion and has shown a cumulative growth.[28] Regarding the financial scope of investment thus far, American investors are the leaders, followed by international companies, Germany, France and Italy. The greatest number of small joint ventures were established by German investors. Considering the structure of the 362 largest foreign investments in Poland by sectors, manufacturing dominates and outpaces the financial sector, followed by construction, services and the energy industry. The main legal barrier for foreign investors which remains after the liberalization of the law on foreign investment in April 1996, is the restriction on the free purchase of land. The obligation to apply for an administrative license in some branches of activity has been removed from the law. In the first half of 1996, a foreign direct investment flow of US 2 billion has already been registered, which means that in this year Poland has crossed the threshold of US 10 billion of foreign investments.[29] This is a significant sum, but foreign investment in Poland are still small measured by the per capita value[30] and from the point of view of needed investment outlays for large projects as well.

2.1.3.3. National Investment Funds program

The legal framework of this program was completed in December 1994 after almost 3 years delay under strong pressure from domestic and international public opinion. At first, the potential members of the supervisory and management boards of the funds and the management groups for the funds were selected by a special governmental commission and afterwards were appointed by the government. Foreign and domestic firms, both individual and those organized in consortia, took part in the bid. The operational part of the program began in June 1995, with the distribution of shares of 413 enterprises among the funds. Finally (together with two additional tranches of enterprises which entered the program at later dates up to June 1996), a group of 512 state treasury companies were handed over to the 15 National Investment Funds for their restructuring and privatization. The distribution scheme was as follows: 60% of the shares of each enterprise were placed in National Investment Funds (NIFs), 15% were given free to the employees of the relevant company and the remaining 25% have been temporarily withheld by the state treasury for later placement in pension funds and compensation programs. The law provided that the 60% of shares expected to be distributed among the 15 funds have been divided in majority and minority stocks, in order to avoid too large a dispersion of the shares. As a result, 33% of the shares of each company have been located in one fund and the remaining 27% evenly dispersed through all the remaining funds. The minority shares are freely tradable and the majority shares only as a whole. The funds managers are responsible for the increase of the entire value of their funds and are expected to fulfill this task through different activities such as direct or indirect restructuring of the enterprises, supporting them on their way to privatization and seeking for strategic investors for them. They may also sell the enterprises or liquidate them. Portfolio activities are also expected to be an important part of the NIF activities.

The distribution of share certificates among the Polish population took place from November, 1995 until November, 1996 and, according to the most recent information, the vast majority of people eligible to participation in this program (27.8 millions), bought the certificates for their registration fee which was at the end of the distribution seven times lower than their current market value. The certificates are freely tradable on the private secondary market and on the stock exchange, and, after the NIF funds enter the stock exchange, each certificate will be exchangeable into a package of one share in each fund. This is expected to be during the first half of 1997.

[27] The Polish Agency for Foreign Investment is only monitoring the group of larger investments (higher than 1 million). However, this group includes about an 80% share in the total foreign investment.

[28] All data from the statistics of the Agency of Foreign Investment as of December 1995.

[29] Reisinger (1996).

[30] For example, in 1994, the per capita FDI in Hungary achieved 691 USD, in the Czech Republik 300, in Estonia 291 and in Poland only 114 USD. Source: PAIZ

At the beginning of their work, the funds started with feasibility studies of their "majority" companies, in order to prepare plans for their restructuring or sale. They were also obliged to provide consolidated balance sheets for the first year of their operation (1995), and to provide other documents, in order to obtain from the Security Commission, permission for entering the Warsaw Stock Exchange. The experience of the first year shows that the funds tried to conduct an active and differentiated restructuring and investment policy towards their enterprises. In most cases they differentiated between enterprises which are in better position and could be sold earlier, and enterprises that need longer restructuring time in preparation for privatization. As of August 1996, plans of the funds to sell 76 of the 512 majority stocks held, were presented. In 9 cases the process was already begun. The entrance to the stock market of 64 NIF companies is also planned. The sale of minority stocks additionally began in the spring of this year, especially in the cement industry. Because of difficulties in corporate governance over a large number of companies, six NIF funds decided in October, to exchange their minority shares in order to consolidate them into larger stocks. As a result, in 162 NIF companies, the distribution of shares is as follows: one fund — 33%, a second fund — 9.6% and nine other funds — 1.93% each.[31]

The sectoral and branch composition of the 512 enterprises handed over to the NIFs is as follows: industrial enterprises dominate the whole NIF group (with 417 out of 512 companies). A relatively large part (69 firms or 14.4%), is taken up by construction enterprises. Within the manufacturing sector, machinery and equipment, food and beverages, chemicals, textiles and metallurgy have the largest shares in the program. This is different from the capital privatization dominated by enterprises producing final consumer products. The size of enterprises in the program is, on average medium large (54% of enterprises have between 200 and 1,000 employees; see Table 8). Their financial standing has worsened during the last years in comparison to other companies because of two main reasons: first, better enterprises in many cases have found a strategic investor for capital privatization and have left the NIF program, second, a large number of enterprises designated for mass privatization spent two or more years in limbo, without undertaking serious restructuring efforts.

2.1.3.4 The direct privatization through liquidation method

Direct privatization through liquidation, designed for small and medium sized enterprises was undertaken up to 30 June, 1996 for 1,167 SOEs and was completed in 1,114 cases. There is clear evidence that this is the quickest, most time-effective and most popular way for property rights transfer in Poland (under the governance of the privatization law). In Table 9 and Graphs 3 and 4, the time efficiency of the direct privatization method in comparison with the liquidation under the enterprise law (real liquidation) is shown. Whereas the proportion of started to completed procedures in direct privatization was 95% at the end of the last year, the same measure in the liquidation privatization method was only 31%. The direct privatization method may be classified as a quasi-sale method because of the delay in payments and various legislative measures which ease conditions of purchase. Three basic types of procedures (or combinations of procedures), are possible in liquidation under the privatization law: the sale of an enterprise's assets, leasing or entering them as a contribution in kind, into new companies. In fact, however, in the majority of completed cases, liquidated enterprises were leased to companies formed by the employees of the former enterprises (with a significant share of mangers). The price for such a lease is the result of negotiations without public bid and the payments are made by installments. As of June 1996, leasing has been used in 52% cases of direct privatization, direct sale in 38.7% and contribution in kind in only 8% cases. In previous years, leasing has been used even more frequently than now in the framework of direct privatization.

There is a significant slowdown in the dynamics of direct privatization since the negotiations on the Pact on State Enterprises in 1993[32]. One of the reasons for it may be a diminishing number of enterprises in good financial shape within this group, but the more important reason seemed to be waiting for the new privatization law, which was expected to provide easier financial conditions for this type of privatization. It did to some extent, but simultaneously narrowed the potential group of direct privatization objects to much smaller enterprises. It is important to mention that, unlike other

[31] See Kostrz-Kostecka (1996) and Skupińska (1996).

[32] In December 1991 when there was the highest dynamics of direct privatization, 426 procedures had been started but at the end of 1995, only 107 such procedures had begun.

post-Communist countries, this kind of privatization in Poland is legally dominated by insiders of the enterprises who have priority to initiate privatization and can block such an initiative by an outside investor. Until the recent changes in the privatization law, the government failed to change the rules for direct privatization in order to enable outside investors to act independently from the insiders. It is to early to assess the influence of the new law on the direct privatization process. The performance of enterprises privatized through this method is, in most cases, better than expected but capital investment is very insufficient[33].

2.1.3.5. Liquidation procedures under the State Enterprise Law and insolvency

The Law on state enterprise regulates, among other things, the reform and liquidation procedures of enterprises which are in poor financial condition. In relation to such enterprises, their funding organ may either undertake reform procedures or institute liquidation procedures (article 19 of the law). The assets of these enterprises are sold by the liquidator to third parties in a public sale by auction, and the proceeds go to pay off the creditors. Liquidation under this law is forced because of poor financial conditions and privatization of the assets of the liquidated enterprise is merely a by-product of the procedure. Nevertheless, liquidation under Article 19, supports privatization processes on a significant scale. It allows small private firms to acquire assets of liquidated state enterprises relatively cheaply. Though the enterprises cannot survive in their old form, their assets can be used in a more effective way and their employees can find new employment. The purchaser of assets, or in many cases, of factories, or even of whole enterprises privatized by this procedure, are better off than in the case of direct privatization because they are not forced to continue the activity of the enterprise in the old organizational shape. On the other hand, the procedure of art. 19 liquidation is much more complicated and takes more time than direct privatization. Up to June 1996, decisions about the liquidation of SOEs were taken in 1,427 cases but only 437 (31%) liquidations have been completed. The remainder (over 900 liquidations), are not yet completed (see Table 9 and Graph 4).

In order to obtain a more accurate picture of the ownership changes in the economy, one should also mention the bankruptcies. Since 1990, a growing number of state-owned enterprises have been involved in bankruptcy and court agreement procedures. In June 1996, some 580 state-owned enterprises were involved in bankruptcy procedures or restructuring procedures controlled by the court and the creditors[34]. In several insolvency cases, the creditors decided to take over the enterprises and to become the new owners. Different from administrative liquidation, the main decision maker is here the receiver appointed by the court.

Furthermore, from 1993 to 1996, under the new enterprise and bank financial restructuring law, banks have started composition agreement procedures in relation to indebtedness in 182 cases of state enterprises and companies. The law provided for enterprises restructuring procedures such as: banking conciliation agreements, the public sale of bank debts, debt to equity swap, and liquidation or bankruptcy. In September 1996, the Ministry of Privatization registered debt to equity swaps[35] in 116 cases. These procedures lead to the partial privatization of the enterprises concerned, and in some cases, to full privatization. Twenty banks and the Agency for Industrial Development have been involved in the conciliation agreements. The participating enterprises were located mainly in industry and of them, most number was in electro-machinery and textile industry.

2.2. Macroeconomic results and sectoral changes

From the macroeconomic point of view, besides the robust economic recovery which has resulted in a GDP growth of between 5 and 7 % yearly since 1994, we also observed a systematic change in the ownership structure in the economy and reorientation toward new markets. After six years of transformation in Poland, the privatization of the economy – in its broadest sense – has reached a significant scale. The share of the private sector in the economy (measured by its GDP share), increased from 30% in 1989[36] to 56% in 1995.[37]This share is, in our view still to low and should be risen to 80-85% in the future, providing that the majority of industry will be private.

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[33] An evaluation of the evolution and performance of these companies is given in: M. Jarosz (1996).

[34] See GUS, *Prywatyzacja przedsiębiorstw państwowych*, 30 June, 1996, p. 81.

[35] See MPW, "Dynamika", no. 30, p. 45-48.

[36] More detailed: the share of the private sector in the GDP was only 19.2% in 1989, and of that the share of the nonagricultural private sector only 9.2%. The cooperatives, producing at that time some 10% of the GDP,

At the end of 1995, the share of the private sector in industrial output was 44%, in construction 87%, in transportation 45%, and in domestic trade 92%. The share of the private sector in exports was 57% and in imports 70%. Altogether at the end of 1995, the private sector in Poland (including agriculture), employed 62% of the work force and created nearly 56% of the GDP.[38] Table 10 illustrates the changes in the private sector's share in the economy from 1989 to the end of 1995.

The sources of the impressive economic recovery of the Polish economy after the transformation were mainly located in the private sector, which developed rapidly thanks to the liberalization of the market and the soft entry regulations in the initial stage of transition. From 1991 to 1995, value added in the private sector grew at rates ranging from 7.0% to 26.7%, whereas in the public sector, it declined systematically and only recovered in 1994, with a growth of 2.8%.[39]

There are substantial differences in the composition of production in the private and public sectors. In the public sector, industry is responsible for the bulk of production growth, with the remainder produced by transportation and a very small share by other sectors. In the private sector, the main producer is trade, followed by industry, construction, and agriculture respectively. In presenting the share of the different sectors in the GDP, it is worth noting that the public sector, though employing less then 40% of the labor force, still disposes of more than a half of all national assets (e.g., 59.1% of their book value in 1994), and has also a larger share in the total investment outlays in the economy (56% in 1994)[40]. Agriculture, though employing 27% of the total work force, produces only 6.6% of GDP, which is evidence of a very low labor productivity in this sector. During the period under consideration, massive shifts in employment among the sectors emerged as well. These changes are shown in Tables 10, 11 and 12. We can see that, together with private agriculture, employment in the private sector reached 50% of the total work force as early as 1990 and by the end of 1995, exceeded 62%. However if we look closer at the structure of employment (excluding agriculture), we can see that employment in the remaining private sector (without cooperatives), rose from 1.8 to 4.6 million between 1989 and 1995 (Table 12). This figure includes persons employed in all private companies and partnerships, but primarily consists of a large number of self-employed. At the same time, employment in the cooperative sector shrank from 2.2 to 0.7 million. Altogether employment in the private sector rose from 8.2 to 9.3 million. On the other hand, the work force in the public sector shrank from 9.3 to 5.6 million, that is by 3.7 million, and total employment in the economy declined from 17.5 to 14.9 million, that is by 2.6 million. This means that the private sector employed a significant number of former public sector employees, and also a large number of former employees of the "socialized" cooperative sector which became private and underwent serious restructuring.

If we go back to Table 10, we can see that the share of private employment in different sectors of the economy was, and still is, uneven. In industry, this share was 29.1% in 1989 and it rose very gradually, but not reaching the threshold of 50% until the end of 1995. In construction, it rose very steeply from 37.4% in 1989 to 80.9% in 1995. In domestic trade, as early as 1989, private employment (including cooperatives) accounted for 72.7%, and its share increased to 94.1% by 1995. Among the sectors of material production and trade shown in this table, transportation is the only one where the share of the private sector is still lower than 30% (due to the state-owned railways, ports, airlines, postal services, telecommunications, etc., belonging to that sector). Table 13 illustrates the structure of employment in more detail, and there we can see very clearly the uneven degree of privatization among the sectors and branches of the economy. As we can see, in 1995 the share of private employment was 80 % in construction and over 90% in agriculture and trade. In some kind of services (such as real estate), it amounted to more than 60%, but it was almost totally absent in some other services, such as education (2.8%) or health and social services (4%).

In the three main divisions of industry the share of the private sector is very uneven. On average, industry is 50.5% privatized. But whereas private employment has reached 60.4% in the

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were not included in the private sector but in the "socialized sector". For comparability reasons they have been added to the private sector, resulting in the 30% share in GDP. GUS, *Rocznik statystyczny*, 1990, p. 122. For clarification see also Table 3.

[37] OECD estimates of June 1996.

[38] Estimated by OECD. The value added tax produced by the private sector was estimated by the Central Planning Office at 58% (excluding the value added tax and other payments related to imports). See Centralny Urząd Planowania (1996).

[39] Błaszczyk et al. (1996).

[40] GUS, *Mały rocznik statystyczny*, 1996, p. 329.

manufacturing sector, in both remaining sectors of industry (mining and quarrying and electricity, gas and water supply), it stands at 3.1 and 3.6% respectively.

It is important to note that the impressive structural shifts between the public and the private sectors described above, have not been achieved in the way that was expected at the beginning of the reform process. The explosion of newly-founded private firms was the main driving force behind ownership transformation, followed by the decentralized "bottom-up", or direct, methods of privatization of state property. The contribution of centralized, "top-down" privatization methods controlled by the government, and much more under the influence of political fluctuations, has been much smaller. An important factor in changing the whole economic structure was also the systematic contraction of the public sector. Evidence for these claims can be found in the fact that former public enterprises comprise only a small part of the private sector, with regard to their share in employment and to the employed assets.[41] Further evidence may be seen when we analyze employment in the private sector according to the different legal format of companies and businesses. The majority of the work force in the private sector at the end of 1994 (more than 70% including agriculture), was located in one-person businesses and as much as 58.5% of persons working in such businesses related to individual farms. Only a part of this employment could result indirectly from the privatization of state enterprises. On the other hand, employment of 1.9 million persons in private companies and partnerships, at the end of 1994, represented almost 13% of the total work force and about 21.4% of the private sector employment. This group included all greenfield private companies as well as privatized former state-owned companies.[42] Employment in the latter (some 360 thousand), accounted for only a small part of total employment in this group of companies (some 19%).

The revenues from privatization for the state budget should be briefly mentioned here since they have played an important part in the governments' privatization policy. In the years between 1991 and 1995, they ranged from 0.8 to 3.2% of the total revenues of the state budget[43], and from 0.2 to 0.8% of GDP.[44] These figures are not very impressive but they cannot be treated as insignificant for the state budget. The main source of this income was the sale of companies' shares within the so called capital privatization. From 1994, the sale of shares of privatized banks became the second important source. The remaining sources were payments to the state treasury for leased and sold assets. Table 14 shows the state revenues from privatization in the years between 1991 and 1995, and the respective sources of privatization inflows. The rising budgetary revenues from privatization have not been excluded from other budgetary revenues and have been spent in accordance with the daily needs of the budget. Beginning in 1996, a part of these revenues, namely the receipts from the sales of assets of enterprises being liquidated because of poor financial condition, will no longer be transferred to the state budget but retained in a special fund by the newly established Treasury Ministry for the financial support of other liquidation and insolvency procedures.

3. Lessons and prospects for privatization. Remaining questions and things to do

For many reasons, a multi-track approach to privatization has been chosen in Poland. We have succeeded in some of these tracks and failed in others. Especially, we are lagging behind other countries in privatization of the largest enterprises in the heavy industry and infrastructural sectors. On the other hand, we succeeded in developing the new private sector (which is often described as *green field* privatization), in small privatization and in direct privatization of smaller state enterprises, driven by bottom-up initiatives. Besides the impressive spontaneous development of the private sector the

[41] Only 5.5% of the total working force was employed at the end of 1994 in privatized enterprises, where more than 50% shares belonged to private sector (See GUS, *Mały rocznik statystyczny*, 1995, p. 343). In the whole enterprise sector (6,667 units, employing more than 50 persons), 25% of all units were private at that time, but only 15% of their total assets and 12% of employment belonged to the private enterprises. See Przybyłowicz (1995). According to an official statement of former Deputy Minister of Ownership Transformation Jan Czekaj, the share of privatized assets in mid-1996 was equal to 20-25% of the total assets of former state enterprises. Other data indicates that at the end of 1995, employment in enterprises having initiated privatization procedures accounted for 9.7% of total employment, and 32.9% of industrial employment. See Antczak (1996).

[42] See Balcerowicz and Kloc (1996).

[43] See Centralny Urząd Planowania (1996).

[44] Antczak (1996a).

degree of the privatization of the economy, measured by the share of the private sector in GDP, employment and assets is still not satisfactory. Looking at the qualitative results of privatization we have also to admit that only some expected goals could be achieved.

– Thanks to privatization a fast developing capital market in Poland has been established, which is evaluated as the most transparent, best regulated and most promising security market in Central Europe[45].

– The state sector has been diminished but at a much smaller scale then planned.

– The state budget received direct revenues from privatization that were not very impressive but not insignificant and could be used for its consolidation. Indirect benefits from privatization for the budget, resulting from the raising tax collection and declining subsidies for the state sector are already in place and, can be expected in the future[46].

– After six years of ownership transformation there are no doubts that privatization accompanied by pro-competition measures supports the rise of economic efficiency in enterprises. Significant restructuring effects have been achieved in large enterprises privatized by the use of commercial methods, especially with the participation of foreign investors, although the number of those enterprises in comparison to the existing state sector is still small.

– New groups of share owners, especially among enterprise's employees, arose. However, as in other post-Communist countries, the wide dispersion of capital ownership among the population through privatization sought by some reformers has not been achieved.

Altogether, as stated by an official document from November 1996[47], "*besides substantial achievements, the privatization process of the state sector has not reached its turning point yet, the share of the public sector in the economy is still high and does not meet the standards of the market economy.*" According to this document, an intensification of the privatization process through new projects and incorporation of new sectors[48] into this process is needed in order to accelerate the speed of privatization and to maintain the high growth rate of the economy. This statement shows that an evolution of the government's attitude towards privatization has taken place: as recently as two years ago there was a governmental discussion on a "map of privatization" including a long list of "strategic sectors" that should stay in public ownership[49]. At the end of 1995, in a program of privatization through the year 2000[50] there was, for the first time, a statement that no reason exists to exclude any sector from privatization. In 1996 preliminary work on the privatization of the energy sector, telecommunication and other infrastructural sectors started and these sectors have been listed in the privatization draft for the next year.

Appreciating this kind of attitude one should not overvaluate its political reliability. The statements and plans listed above represent first of all the views of the former Ministry of Ownership Transformation and have support of only a part of the governing coalition. There are still many open and hidden opponents of a broad and fast privatization, within political elites as well as among rank and file people, especially the employees of such sectors as coal mining, railways, postal and telecommunication services etc. However, one should add here that, according to public opinion polls, the attitude of the Polish population to privatization seems to change gradually and starts to become more

[45] Recently, this opinion has been expressed by Mr. Yoshiyuki Takemoto, the President of Daiwa Europe Limited and by Mr. Jacek Krawczyk, the President of IB Austria Securities (Warsaw) SA. See: "Gazeta Bankowa", No. 50, 15 December 1996.

[46] Antczak M. (1996 a)

[47] See *Kierunki Prywatyzacji w 1997 roku* (Directions of Privatization in 1997, Annex to the State Budget for 1997) . Warsaw 1996.

[48] Such as energy production and supply, telecommunication, "heavy" chemistry, petrochemical sector, alcohol production etc., See *Kierunki* (1996).

[49] This attitude was presented in several governmental documents, for example in:*Projekt stanowiska rządu w sprawie przekształceń przedsiębiorstw panstwowych* from July 1994 and in *Stanowisko rządu dotyczące określenia gałęzi gospodarki i rodzajów przedsiębiorstw, nad którymi właściwe organy państwowe będą sprawować kontrolę* from February 1995. Opinions on these documents are published in: *Opinie, stanowiska i oświadczenia przygotowane w latach 1991-1996*, Rada Przekształceń Własnościowych przy Prezesie Rady Ministrów, Warszawa 1996

[50] *Program prywatyzacji zasobów majątku państwowego do roku 2000*, Ministry of Ownership Transformation, Warsaw, 25. November 1995

affirmative than at the beginning of the transformation process[51]. Notwithstanding the visible trend for a broader understanding of the importance of privatization and the growing awareness of the need to involve foreign investment in this process, this evolution seems to be still much too slow from the point of view of the scale and urgency of investments needed to modernize the Polish economy.

Obstacles have been placed in the way of faster forms of privatization (such as mass privatization) by political factors. The almost three-year blockade of the NIF Program, its limitation to a smaller scope than previously planned, and an inability to pass the reprivatization law, stood in the way of the privatization of many enterprises. The high involvement of employees and enterprise managers in the privatization procedures, and the preferences given to those groups in acquiring privatized assets, did not give a guarantee for fast privatization, as had been expected by the law. Directors and workers' councils, which were in many cases the initiators and main actors of the transformation process, have especially shown great activity in this area. However, the privatization process has also been hindered many times by certain worker elites; for example, by trade union organizations demanding the implementation of their preferred solutions, sometimes at the cost of other social groups.

The real result of the privatization process is still not satisfactory because of the remaining high number of state-owned enterprises (more than 4000 in December 1995), the high value of resources remaining in the public sector (estimated by the government at 141.8 billions new złotys[52]), and, last but not least, because of an uneven pace of privatization in different sectors, especially in the infrastructural sectors which, so far, have been almost completely left out of privatization.

There is still a group of giant state-owned enterprises which remain unrestructured, highly indebted, avoiding the payment of taxes to the state budget and even to the social insurance funds, and, because of political reasons, remain "untouchable." Instead of liquidation or radical reduction of the scope and activities of these enterprises the government has been forced to finance their survival from the budget. But so far, in most cases, the politicians have not been sufficiently resistant against the political pressure of these groups.

Another group of largest enterprises belonging to the state sector (for example the telecommunication company or the largest petrochemical company) are located in the top ten on the list of 500 largest enterprises and produce huge profits. But these profits are, to a large extent, due to their monopolistic position in the economy, protected from the foreign competition.

A cursory glance at the analysis of "privatization resources," as the state property to be privatized is called, shows their enormous concentration: about 95 per cent of the property was located in about 400 state-owned enterprises or state treasury companies, whereas the remaining 5 per cent was dispersed among about 2,800 enterprises.[53] It is clear, therefore, that without the privatization of the largest enterprises, progress in privatization of the capital held by the state will be only marginal. Taking into account the resistance against privatization of the largest enterprises one can foresee that without launching new, large privatization programs that would raise the demand for privatized assets (such as distribution of compensation and pension vouchers), there is little chance of a more dynamic privatization. On the other hand, the failure to privatize certain particular sectors (due to the fact that they are politically considered as "strategic"), would lead to a drastic reduction of the "privatization resources." And without the privatization and consequent large investments in the power industry, coal, gas, telecommunications, transport and other infrastructural sectors, as well as banks and insurance, it will be impossible to compete with more developed economies and to maintain the strong growth of the economy.[54]

The question is, will the present government be able to overcome the political barriers to these changes? Thus far, experience gives us little occasion for optimism. On the contrary, we observe new

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[51] Results of a representative public opinion survey conducted in April-May 1996 showed that a positive opinion on the need for and benefits from privatization were expressed by more than 70% of the population. However, there was still little support for privatization of largest enterprises (more than 50% was against), for the privatization of public utilities and for an unlimited sale of land to foreigners (only 5% for). See: Informacje o wynikach sondażu: *Postawy Polaków wobec przekształceń własnościowych*, in: "Dynamika Przekształceń Własnościowych", No 30, Ministry of the State Treasury, Warsaw 1996.

[52] See *Kierunki*, 1996, p. 3

[53] See Czekaj (1996).

[54] This opinion was expressed by Jan Czekaj (until very recently the Deputy Minister of Privatization) during the session of the Council on Socio-Economic Strategy on November 28, 1996.

political attempts to establish giant state-owned holdings[55] in the infrastructure industries instead of their rapid privatization. In our view, such holdings, if established, will be an obstacle to the privatization of these sectors and competition within these sectors.

There is no clear policy on how to use the privatization revenues for the much needed structural reforms of the country. Moreover, the government is "collecting" rising claims on the Treasury (e.g., reprivatization claims and claims resulting from decisions of the Constitutional Tribunal). There is a dramatic need to create and capitalize the new retirement insurance system and to finance the reform of the old one. All these costs are expected to be covered by the privatization revenues. But, because of political reasons, the government has not been able, thus far, to find consensus in this field and to give support to such deep reforms. Simultaneously, the rising budgetary revenues from privatization have not been excluded from other budgetary revenues and have been spent, so far, on the daily needs of the budget. A further significant problem is the lack of a concept and/or political support for the commercialization and privatization of other public services (such as health services or education).

In spite of its flaws and failures, privatization in Poland has also had its positive side. In general, it seems that the restructuring of enterprises privatized in Poland occurs more rapidly than in other countries where the voucher form of privatization has dominated. It is therefore important to maintain this positive tendency while at the same time, extending the scope of the privatization process through the use of nonequivalent methods. It seems that the most effective way of doing this would be to link "capital privatization" with voucher privatization. Thus, for example, a certain percentage of the shares of large enterprises in the power and oil industries, telecommunications, and the banking sector could be channeled into funds to provide for the compensation of various claims and the capitalization of the insurance sector, while, at the same time, strategic investors could be found for the remaining shares.

4. Conclusion and policy recommendations

The current state of the Polish privatization process – although it contains many positive factors does not give reason for satisfaction, either from the point of view of the ratio of private to state property, or from the point of view of a systemic change in the economy. This indicates the need for a shift from what might be called a "defensive" privatization strategy to an "offensive" one. The needed changes consist of activities located directly in the privatization area or indirectly influencing it. Some proposals are listed below:

1. To include in the privatization process the infrastructural sectors and those sectors of the heavy industry thus far excluded from it. To promote the involvement of foreign investors in large infrastructure projects and to prepare needed legal regulations and organizational steps for it (for example, to establish clear concession rules and transparent bidding and approval procedures)[56]. According to different sectors the activities should be differentiated:

– Among the infrastructural sectors, in our view, the best prepared industry for privatization, from the point of view of available legal regulation and the financial situation, is electrical power. Its privatization could start immediately after accepting the energy law by the parliament. However, the methods of privatizing the power plants should be carefully considered, in order to assure the needed amount of investment without leading to a substantial energy price increase in the future. Because of the good financial situation of these companies, packages of their shares could be used for the pension insurance reform.

– Other energy industries, such as the fuel and gas industry, need more legal and conceptual preparation. One should, in our view, first of all aim at unbundling of these sectors, in order to divide the natural monopoly (nets) from their other segments. The government should counteract the strong activities directed to the remonopolization of these sectors and the establishment of non-transparent cross-ownership relations. Furthermore, the government should formulate a clear strategy of the involvement of private investors in these sectors and should urgently prepare the needed regulations for it.

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[55] This danger arose with the establishing of the new holding Nafta Polska. A similar project for Polish Gas has been prepared also in 1996.

[56] Valuable recommendations on this topic can be find in: Laurence Carter and all, *Foreign Direct Investment in Central and Eastern European Infrastructure*, Foreign Investment Advisory Service, The World Bank, Washington D.C., September 1996

– The telecommunication sector could be, in our view, privatized much faster than is planned in the government's privatization plans. This would require fast changes in the legal regulations aiming at demonopolization and liberalization of this sector. A faster privatization of these services could help in a modernization resulting in raising quality of services (which is now very poor) as well as in making funds for the pension insurance reform available.

– The postal and transport services (railways, airlines, ports) will be in our view very difficult to privatize because they have developed strong internal interests against restructuring. Strong and long lasting political action, similar to that observed in some West European countries, is needed to break this resistance.

– The coal mining sector needs a different restructuring program than the programs prepared before. The program should aim at a simultaneous establishing of new working places outside the coal sector and at a radical reduction of this sector itself, which is the largest loss maker in the economy and the place where most fatal work place accidents happen. If these radical changes would be undertaken, profit-making coal mines could be privatized as well.

– Some other sectors, for example the steel sector or the petrochemical companies, have already undertaken serious efforts for their restructuring, with massive state aid, and in our view they could be privatized in the near future, serving also as sources for the retirement insurance reform.

– Other large state-owned enterprises whose privatization has been delayed should be aware that further support from the state budget for them will not be available. The only way of solving this problem is, in our view, the determination of the government to harden the budgetary constraints of these enterprises and to subsequently pave the way for their privatization or liquidation.

2. To prepare new nonequivalent privatization projects in order to raise the demand for shares of privatized companies and subsequently use the privatization assets for the social security reform and for the satisfaction of other social claims on the State Treasury.

After satisfying the recognized claims, the assets of privatized enterprises should be used in our view first of all for the pension insurance reform and, if possible, for other reforms of the social service sector (health care, education) and not for the daily needs of these sectors. In the case of pension reform we can show that the privatized assets can be used in different ways:

– The budgetary receipts from privatization (money) could be spent for compensating the losses of the first segment of the pension system, resulting from contracting out of the younger groups of people who leave the "old" system.

– To compensate these people for their claims against the social security fund one could provide them with shares of privatized enterprises, with share certificates or government bonds exchangeable for shares.

– Another proposal includes the establishment of investment funds provided with shares of privatized companies and to provide people who have claims against the State Treasury with share certificates in these funds which could be exchangeable for units of private pension funds, education funds etc.

The choice of the most appropriate way should be made using economic as well as political considerations. It is not possible to precisely estimate the future market value of privatized enterprises because their price depends on many factors, including privatization policy, price regulations, competition regulations, involvement of foreign investors in the large privatization projects, the future growth etc. Therefore one should rather concentrate on the few tasks which can be really solved using the privatized assets than develop a broad program which may be not realistic. If the value of privatized assets will be higher than expected, the program can be developed also.

3. Besides a strong "push" from the supply and the demand side, which is needed in the privatization strategy, one should not forget that the privatization of the economy (i.e. the development of the private sector itself) still needs strong support. The private sector should be able, as heretofore, to easily purchase assets from the contracting or liquidating public enterprises. Even more important are other factors constituting a friendly environment[57] for the private business, i.e. the rules of entry, stable regulations and equality of rights with the enterprises of the public sector. Subsidies and other forms of support for privileged (i.e. state) enterprises have a destructive influence on the competitive power of other enterprises and may even lead to their bankruptcy. There are numerous examples of small private enterprises, suppliers of large state enterprises which became losers because of the debt restructuring process of their large partners. To the extent that the government continues to support in this way large, inefficient state enterprises, it will be done at the cost not only of the tax payers, but also of the private sector.

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[57] See: Tanaś, Jolanta and A. Surdej, *Wybrane elementy warunków funkcjonowania przedsiębiorstw w Polsce,* CASE, Warszawa 1996

Tables and graphs

Table 1
Number of economic units in public and private sectors on December 31, 1989 and December 31, 1995

Ownership form	State enterprises	Municipal enterprises	Commercial code companies with state majority	Domestic commercial code companies (private)	Joint ventures	Businesses owned by individuals	Cooperatives (with cooperative banks)
1989	7,337	-	1,224	15,252	429	813,145	19,691
1995	4,357	482	2,023	74,299	24,086	1,693,000	19,822

Sources: GUS, Rocznik statystyczny, 1991; GUS, Mały rocznik statystyczny, 1996; GUS (1996).

Table 2
Privatization in retail and wholesale trade in Poland (1990-1995)

Specification	1990	1991	1992	1993	1994	1995
Retail trade sales in million PZL, of it:	26,577.3	46,650.8	67,267.3	96,701.4	130,450.2	170,107.1
public sector	9,651.3	7,845.1	9,132.3	10,524.4	12,011.3	13,081.6
private sector	16,926.0	37,805.7	58,135.0	86,177.0	118,438.9	157,025.5
Wholesale trade sales in million PZL, of it:	–	16,253.6	53,933.3	88,087.5	132,843.9	197,447.6
public sector	–	5,775.8	8,528.7	16,381.4	17,693.4	20,891.9
private sector	–	10,477.8	45,404.6	71,706.1	115,150.5	176,555.7
Number of shops in retail trade (as of end of the year)	237,425	310,966	352,502	380,582	415,449	425,600
public sector	14,312	9,440	9,613	8,620	7,533	6,287
private sector	223,113	301,526	342,889	371,962	407,916	419,313

Source: Small Statistical Yearbook 1996, Main Statistical Office, Warsaw 1996, p. 332.

Table 3

Number of state enterprises subjected to ownership transformations by legal path, June, 1996

Number of state enterprises		As % of enterprises existing on 31 December, 1990	Comments
existing on 31 December, 1990	8,441	100	
transformed into companies of the State Treasury, of which:	1,188	14.1	168 of them has been privatized and 512 transferred to the NIF Program
transformed into companies under Law on Ownership Transformations of Enterprises of Special Importance	155	1.8	temporary not subject to privatization
liquidated under Law on Privatization of State Enterprises (direct privatization)	1,167	13.8	1,114 projects completed
liquidated under Law on the State Enterprise (liquidation)	1,427	16.9	437 projects completed, 441 went into bankruptcy procedures
taken over by the Agricultural Property of the State Treasury	1,654	19.5	
being in liquidation under the Bankruptcy Law	316	3.7	
handed over to local governments under the law on communalization	263	3.1	may undergo further transformations
Total number of enterprises being subject of ownership transformations*	6,015	71.2	
Including: Privatization completed	1,719	**20.4**	

*From the beginning of the transformation process to June 1996 (including bankruptcies and communalization).

Source: GUS, *Prywatyzacja przedsiębiorstw państwowych* (30 June, 1996), and own calculations.

Table 4

Number of state enterprises in the process of ownership transformation in Poland by sectors of economy (1991-1995)

Sectors of economy	State enterprises being subject of ownership transformation					
	1991	1992	1993	1994	1995	June 1996
Industry	511	826	1,167	1,511	1,822	1,968
Construction*	309	517	658	563	626	658
Agriculture**	175	739	1,578	302	340	362
Forestry	3	10	15	17	18	NA
Transport and communication***	71	105	144	189	207	216
Trade	127	186	245	276	344	372

* The decrease in the number of firms in the construction sector results from the change in classification of the economic activities in 1994.

** Data on agriculture for 1994, 1995 and 1996 are from MPW, *Dynamika*.

*** During the time under consideration, only one state enterprise in the communication sector has undergone ownership transformation.

Sources: GUS, *Prywatyzacja przedsiębiorstw państwowych*, 1991, 1992, 1993, 1994, 1995, 1996.

Table 5

Industrial enterprises in transformation process in main branches (1994 and 1995)

Number at the end of the year	1994	1995
Industrial enterprises, total	1,511	1,821
Mining and quarrying	105	115
Manufacturing	1,346	1,644
Electricity, water and gas supply	60	62

Source: GUS, Prywatyzacja przedsiębiorstw państwowych, 1995, p. 36.

Table 6

Share of employment in enterprises having initiated privatization in total employment and in employment in main production sectors, Poland, December 1994 and 1995* (%)

	1994	1995
Total employment	8.9	9.75
Industrial employment	30.3	32.9
Construction employment	14.9	15.1
Agricultural employment	4.8	4.8

* Without communalization and bankrupcies.

Comments: enterprises having initiated privatization include: companies privatized by the capital method (direct sale and IPO),companies with partial State Treasury participation founded with the capital of liquidated state enterprises, employee-owned companies leasing state property (privatized on the basis of Article 37 of the privatization law), corporatized state enterprises designated for capital privatization, mass privatization, and restructuring, enterprises being liquidated in accordance with the law on state enterprises, the law on privatization and the law on agricultural property of the state treasury.

Source: M. Antczak, Diagnoza (1996), mimeo, based on GUS data published in: Privatization (1995,1996) and Small Statistical Yearbook.

Table 7

The structure of companies commercialized and privatized by the capital method in different sectors and branches, as of 31 December, 1995

Sectors and branches	Commercialized state treasury companies	Privatized by capital (indirect) method	
		Total	Of them: with foreign participation
Total economy:	100	100	45.9
Mining and quarrying	3.2	1.3	-
Manufacturing, of it:	75.0	83.0	42.1
- food products and beverages	14.8	15.1	8.2
- textiles	7.9	3.1	-
- wearing apparel	-	5.0	1.3
- chemicals and chemical products	5.7	9.1	3.1
- machinery and equipment	10.5	6.3	2.5
- electrical machinery and apparatus	-	8.8	3.8
Electricity, water and gas supply	5.6	-	-
Construction	10.8	10.7	2.5

Notes: " - " means lack of data.

Source: GUS, *Prywatyzacja przedsiębiorstw państwowych*, 1995, pp. 10, 12.

Table 8
The structure of enterprises involved in the NIF Program by branches of industry and number of employees

Sectors and branches	Total in %	Enterprises with number of employees, in % terms				
		less than 200	201-500	501-800	801-1000	more than 1000
Total	100	13.1	30.7	14.8	8.4	23.0
Mining and quarrying	1.8	0.2	0.4	0.6	0.2	0.4
Manufacturing, of it:	78.7	9.0	23.2	18.2	6.8	21.5
- food and beverages	13.1	3.7	4.7	2.9	0.6	1.2
- textiles	10.2	0.6	2.9	2.1	1.0	3.5
- machinery and equipment	12.3	0.2	3.7	3.3	1.4	3.7
Construction	14.6	1.4	6.1	4.9	1.2	1.2
Trade and repairs	3.3	2.1	0.4	0.8	-	-

Source: GUS, *Prywatyzacja przedsiębiorstw państwowych*, 1995, p. 14.

Table 9
The efficiency of the liquidation procedures under privatization law and state enterprise law in Poland (1990-1996)

As of the end of the year accumulated data	The number of state enterprises in liquidation under the privatization law (direct privatization)		The number of enterprises in liquidation under the state enterprise law (real liquidation)	
	process started	completed	process started	completed
1990	44	13 (29.5%)	28	2 (7.1%)
1991	416	242 (58.2%)	534	32 (5.9%)
1992	662	549 (82.9%)	797	121 (15.1%)
1993	865	733 (84.7%)	1,091	215 (19.7%)
1994	985	913 (92.7%)	1,246	297 (23.8%)
1995	1,098	1,039 (94.6%)	1,379	383 (27.7%)
1996 (June)	1,167	1,114 (95.5%)	1,427	437 (31.7%)

Note: the calculations showing the share of completed cases, as opposed to those started, are shown in brackets.

Source: own calculations based on: GUS, *Prywatyzacja przedsiębiorstw państwowych*, 1995, 1996.

Table 10
Private sector's share in the creation of output according to main sectors of the economy and their employment 1989-1995 (current prices)

Sector of economy		1989 December	1991 December	1992 December	1994 December	1995 December
Industry	a	16.2	24.6	31.0	38.3	44.0
	b	29.1	35.8	41.4	44.8	50.5
Construction	a	25.5	62.2	77.7	85.0	87.0
	b	37.4	59.5	71.8	79.3	80.9
Transportation	a	11.5	25.2	39.3	45.1	45.0
	b	14.3	26.0	23.1	28.1	26.6
Domestic Trade	a	59.5	NA	86.1	91.5	92.0
	b	72.7	88.3	90.5	92.0	94.1

a – share of the private sector in output (in %); b – share of the private sector in employment (in %).
Sources: GUS, *Rocznik statystyczny*, 1991, 1992, 1993, 1994, 1995; *Mały rocznik statystyczny*, 1994, 1995, 1996; CUP data for GDP share in 1995.

Table 11
The structure of employment in public and private sectors in Poland, 1990-1995

	Total	Public sector		Private sector*	
	in 1,000	in 1,000	%	in 1,000	%
1990	16,474.0	8,243.4	50.0	8,230.6	50.0
1991	15,861.2	7,052.1	44.5	8,809.1	55.5
1992	15,494.5	6,606.4	42.6	8,888.1	57.4
1993	14,761.2	6,060.3	41.1	8,700.9	58.9
1994	14,924.0	5,878.4	39.4	9,045.6	60.6
1995	14,967.9	5,623.1	37.6	9,344.8	62.4

* Private sector including agriculture.
Source: *Mały rocznik statystyczny*, 1996, pp. 329, 330.

Table 12
Employment in the national economy by sectors (as of December 1989 and 1995) in millions

Sectors	1989	1995
private sector	5.8	8.6
agricultural	4.0	4.0
non-agricultural	1.8	4.6
co-operatives	2.2	0.7
other "socialized" entities	0.2	na
total non-public sector	8.2	9.3
public sector	9.3	5.6
state ownership	9.3	4.7
local government ownership	-	0.9
total employment in the national economy	17.5	14.9

Sources: GUS, *Rocznik statystyczny*, 1991; GUS, *Mały rocznik statystyczny*, 1994, 1995, 1996.

Table 13

Employment in branches of the Polish economy by the public and private sector (1993-1995), in 1000 employees

Sector	1993		1994		1995		
	public	private	public	private	public	private	private as % of total in each branch
total	6,060.3	8,700.9	5,878.4	9,045.6	5,623.1	9,344.8	62.4
agriculture	200.0	3,722.8	164.1	3,852.7	127.2	3,905.1	96.8
industry, of which:	2,157.6	143.8	2,004.4	1,629.6	1,845.0	1,883.8	50.5
mining and quarrying	391.1	7.7	375.0	10.7	346.0	11.1	3.1
manufacturing	1,515.7	1,469.8	1,354.8	1,611.5	1,239.7	1,862.8	60.4
electricity, gas and water supply	250.8	6.3	274.6	7.4	259.3	9.9	3.6
construction	268.1	612.6	172.7	661.1	157.8	669.6	80.9
trade and repair	143.9	1,838.3	1.18.8	2,097.1	111.6	1,791.5	94.1
transport, storage and communication	596.4	226.9	645.3	192.7	614.4	223.7	26.6
financial intermediation	146.5	75.1	162.5	74.9	170.7	97.5	36.3
real estate and business activities	240.5	330.1	177.6	294.0	203.2	351.1	63.3
public administration and defense	336.1	0.5	356.6	0.2	381.0	0.3	0.07
education	849.5	21.8	857.4	15.1	871.6	24.8	2.8
heath and social work	934.8	54.4	949.2	37.1	962.6	40.8	4.0

Source: own computations based on GUS, *Mały rocznik statystyczny*, 1996, p. 330.

Table 14

Direct income from privatization of state enterprises and banks in Poland (1991-1995)

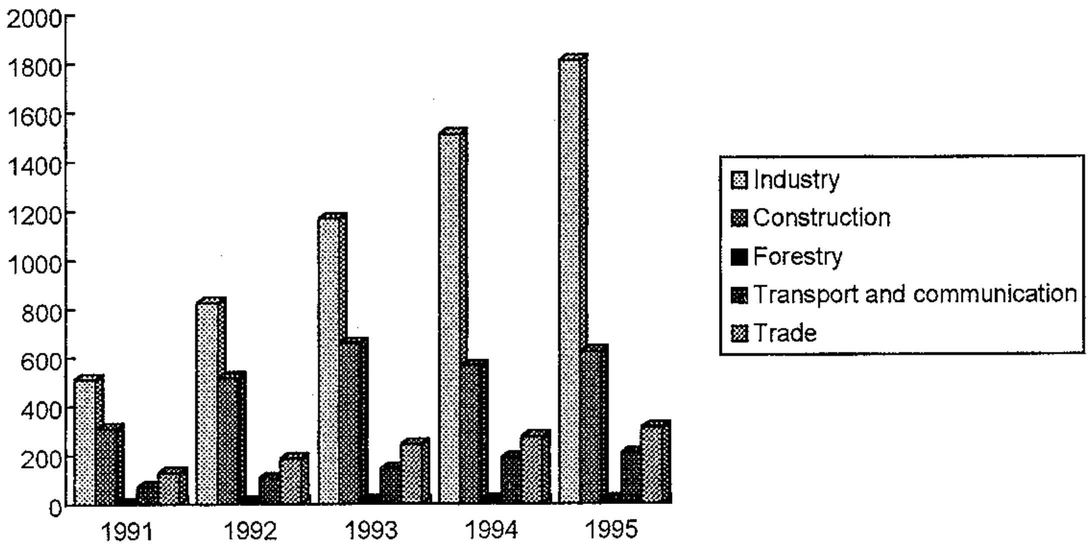
	1991	1992	1993	1994	1995	1996*
in millions of PLZ						
Total income from privatization, of them	170.9	498.8	789.4	1,614.7	2,641.6	3,220
capital privatization	125.5	323.1	448.4	866.6	1,714.2	1,800
lease, liquidation and rent payments	30.4	171.8	287.0	322.9	406.1	590
bank privatization	-	3.9	54.0	425.2	521.3	830
others	15.0	-	-	-	-	-
in %						
Income from privatization as a % of budgetary incomes	0.8	1.5	1.7	2.6	3.2	3.2
Income from privatization as a % of GDP**	0.2	0.4	0.5	0.8	0.75	0.79

* Estimated

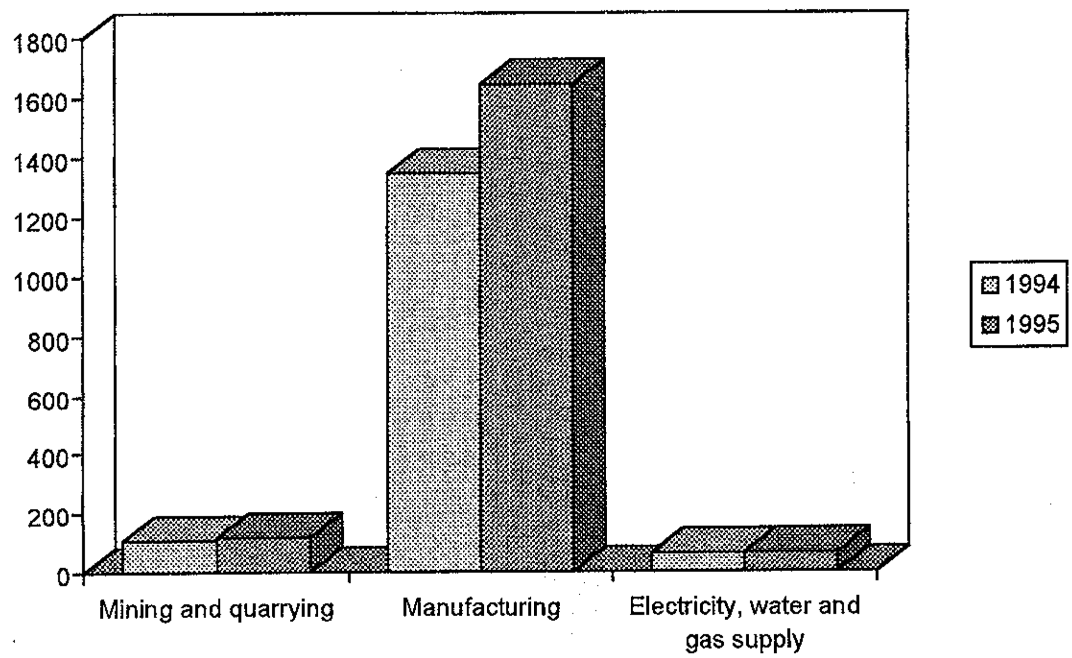
** For 1991-1994 from Antczak (1996); for 1995-1996 own calculations.

Sources: Centralny Urząd Planowania (1996). 1996 estimations from the state budget draft from November 1996.

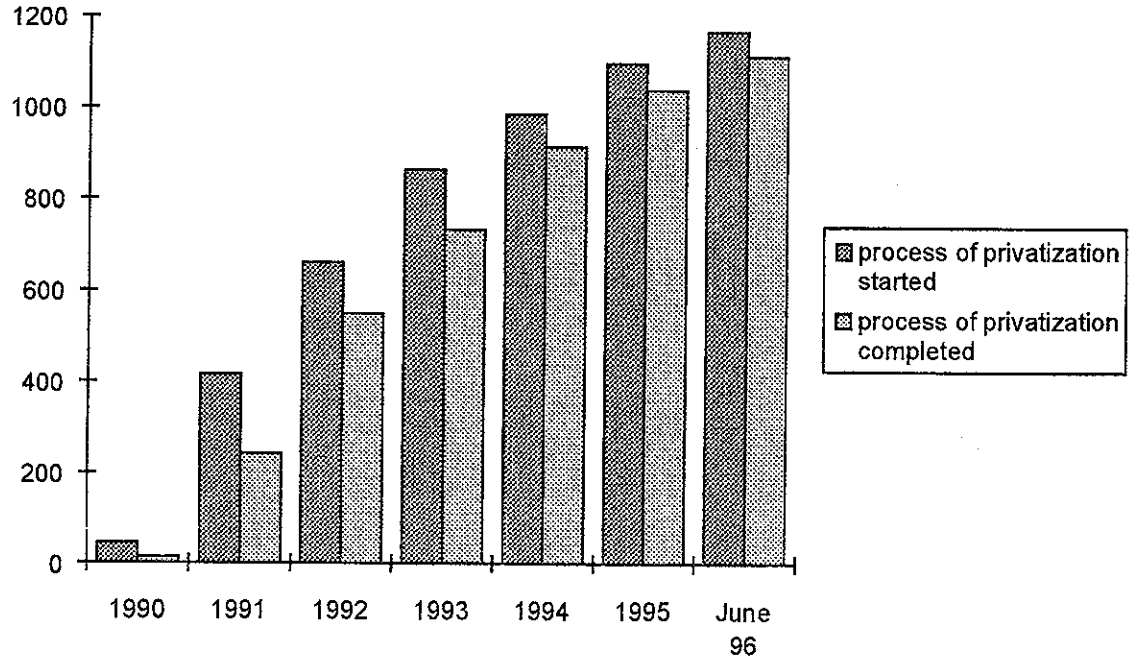
Graph 1
The number of enterprises in the process of transformation by sectors



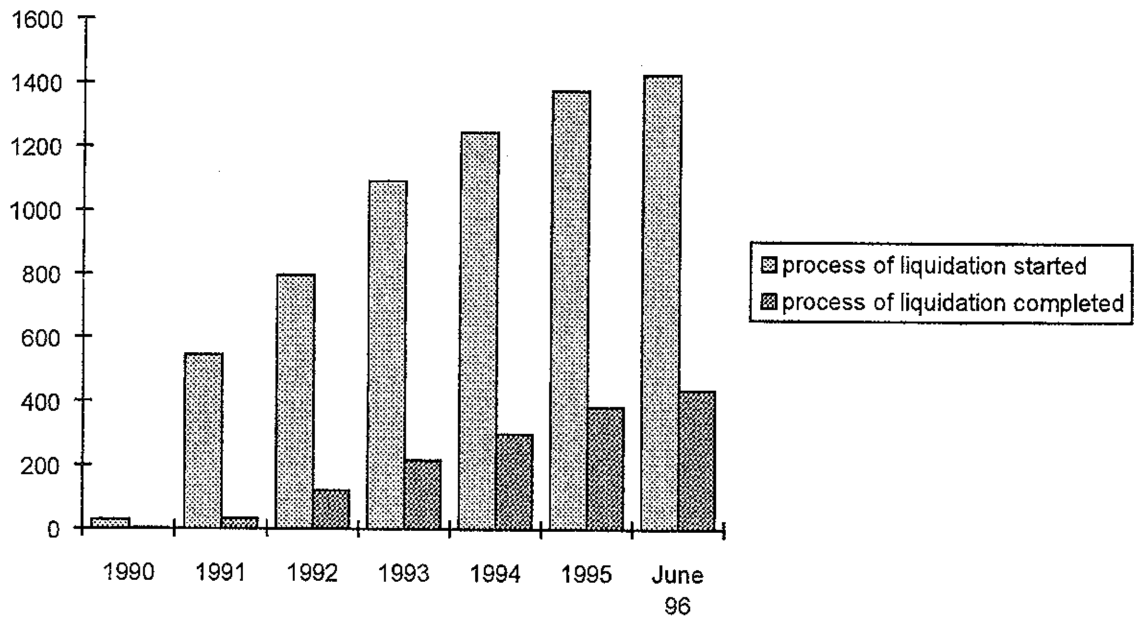
Graph 2
Industrial enterprises in transformation process by branches



Graph 3
State enterprises in liquidation under the privatization law (direct privatization)

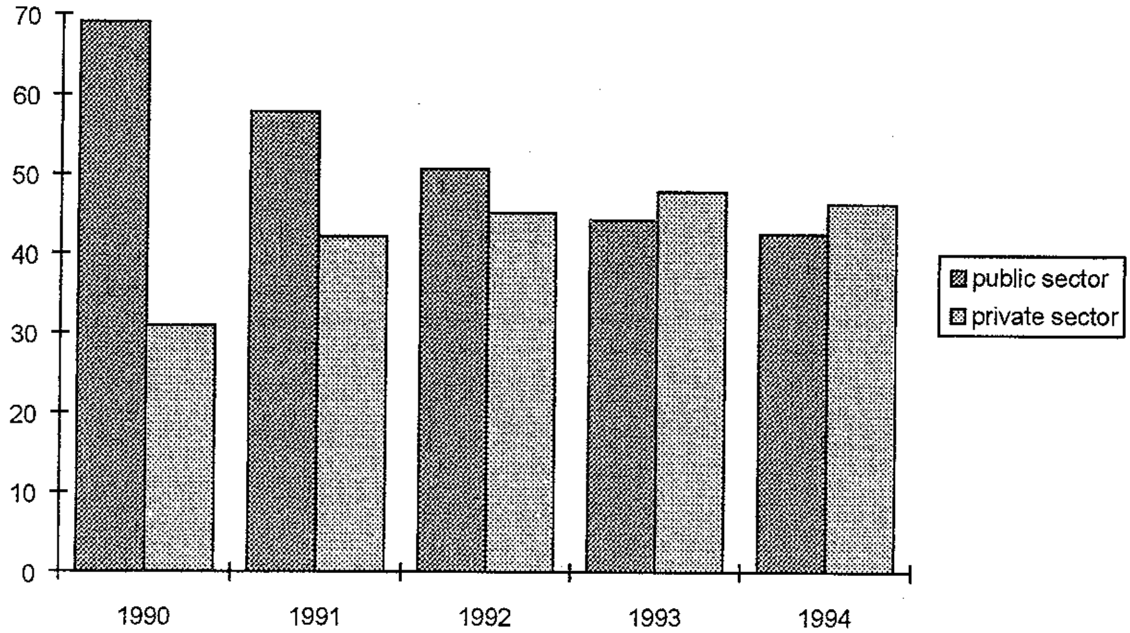


Graph 4
State enterprises liquidated under the state enterprise law



Graph 5

The Composition of GDP in the Polish Economy 1990-1994. The share of private and public sectors in %

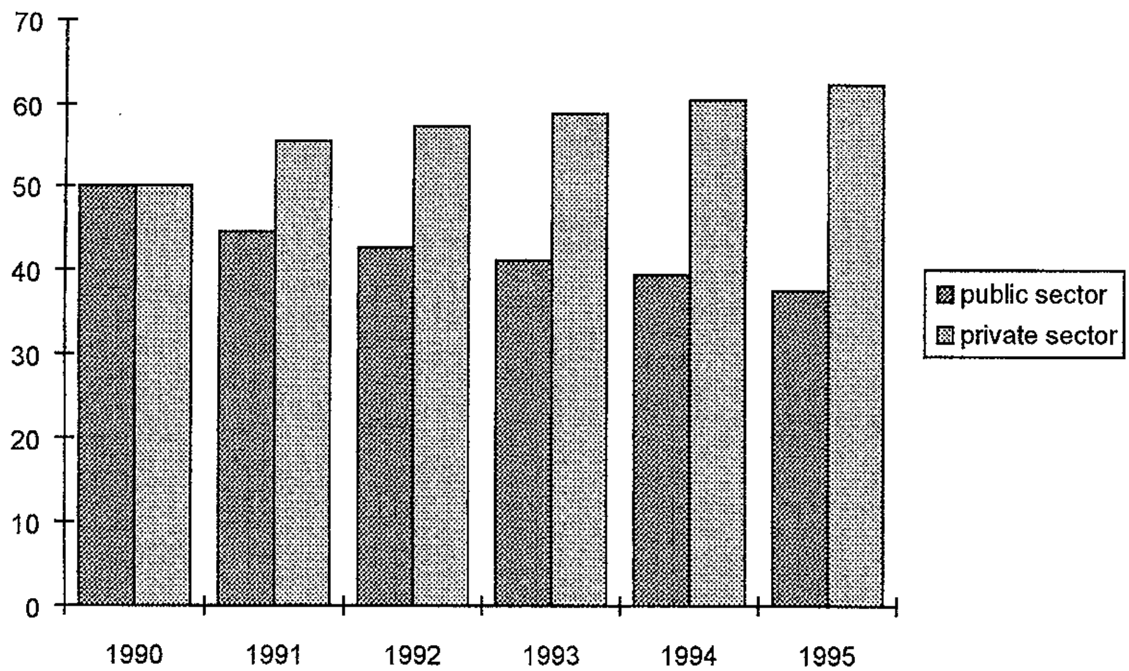


Notes: The private sector share in total GDP for 1994 was 46.4% and the public sector share 42.5%. The remaining 11.1 % included tariffs and other import-related payments as well as the value-added tax which are not accounted as the input of any sector, thus the figures do not sum to 100%. The share of the private sector in total employment in the economy was 60.6%.

Source: Small Statistical Yearbook GUS 1996, p. 329.

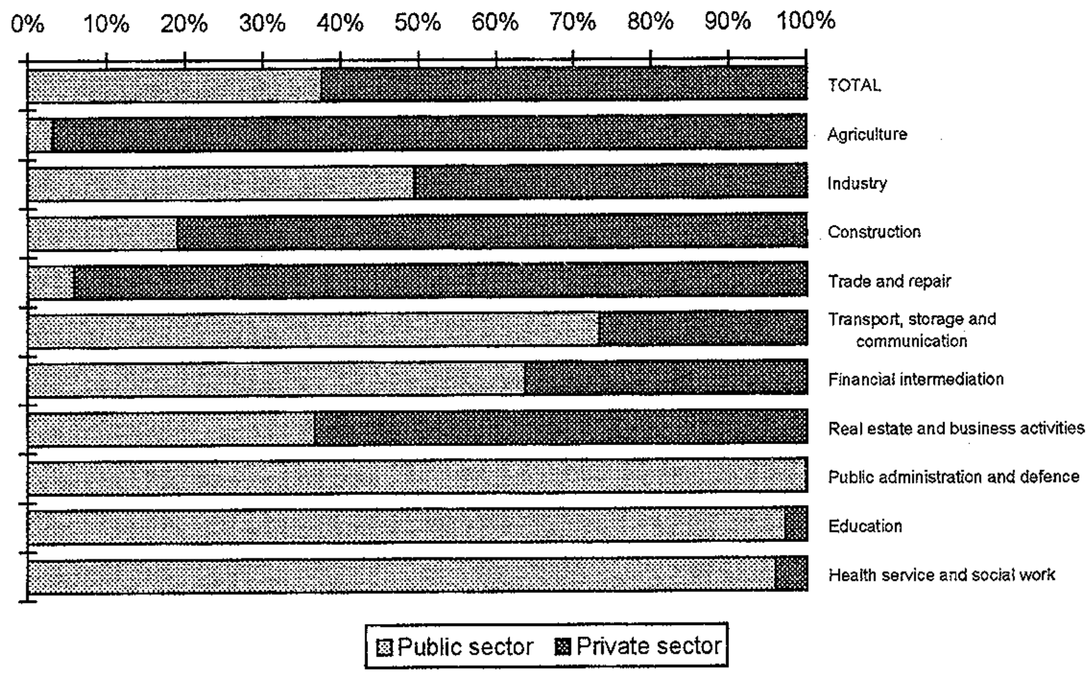
Graph 6

Employment in private and public sectors in %



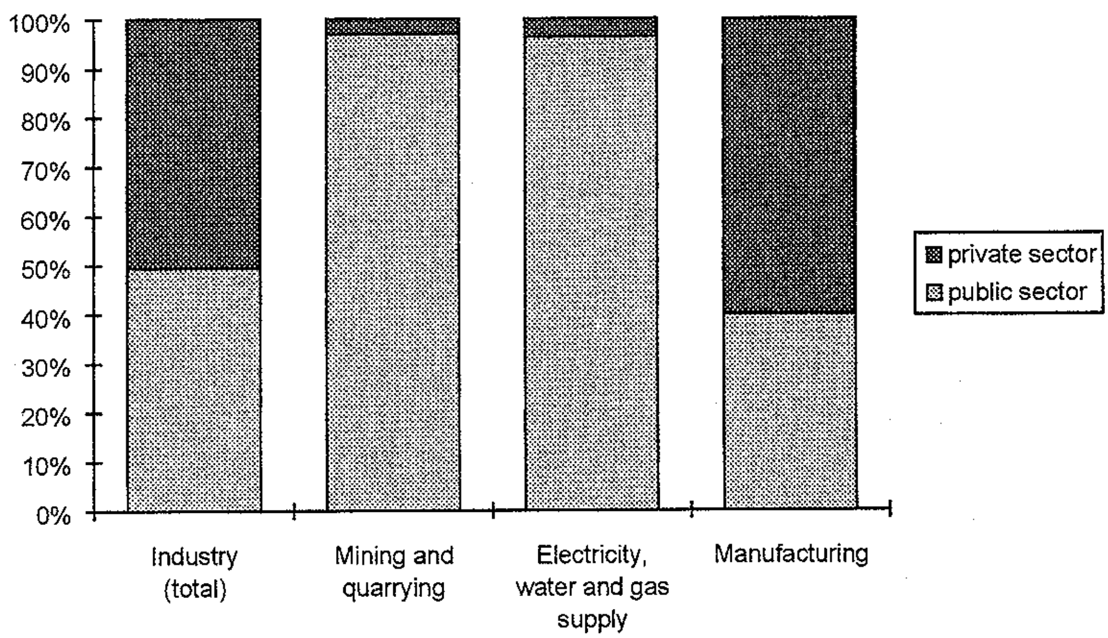
Graph 7

The employment in public and private sectors by branch in 1995



Graph 8

The share of private and public sector in different branches of industry measured by employment



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THE MODEL OF THE POLISH FINANCIAL SYSTEM CONDUCIVE TO MAXIMIZATION OF LONG-TERM ECONOMIC GROWTH

Sławomir Lachowski

This present paper aims to explore the attempts at designing a target model of the Polish financial system which could be capable of nourishing a long-term economic growth. When tackling such a valiant task one should bear in mind that the design of such a model assumes its sustained functioning in the future on the basis of current assumptions, drawing on the information available at present. Changes which will over time have occurred to the conditions in the environment may have a bearing on the details of the target model, nevertheless the general principles governing the design of the system and the manner in which it functions should remain unchanged.

Given the experiences gained throughout the transformation processes completed to date, the present shape of the Polish financial system to a certain extent gives an indication of what the nature of internal limitations of the future development processes may be.

When considering the target model of the Polish financial system there is a need to take into account dramatic changes afoot in the financial sector world-wide, and focus especially on those taking place in Western Europe. Some of those changes are specific to Europe and stem mainly from continued progress in the integration processes in the European Union, while others have a global significance. Given Poland's attempts at securing membership of the European structures, the design of the future financial system should view the changes and development trends observed in the European financial system as if they were an integral element of our own economic reality.

The discussion of the target model of the Polish financial system that follows takes into consideration the main criterion driving the choice of its shape, namely the need to maximize the long-term economic growth of the country. Additionally, a number of other external factors were taken into account which impact on the development prospects of the Polish financial system:

– The need to harmonize provisions of the Polish financial law with those in force in the European Union so as to create conditions conducive to generating such alignments in the Polish financial sector which will enable it to function within the Single Financial Services Market.

– Consolidation in the financial sector is equally strongly manifested in the domestic and international markets, both when viewed across individual industries, and considered against the background of emerging trends visible in the growing number of multifunctional financial conglomerates. The trend to consolidate is commonplace, and in the countries of the European Union has been further strengthened by the expectations connected with the introduction of the economic and monetary union and common currency, as stipulated by the Maastricht Treaty.

– Increasing competition in the financial markets manifested by the growing scale of competitive pressure within individual industries where — to quote but one example — banks are under increasing competitive pressure exerted by non-banking institutions (retail chains, industrial conglomerates and investment funds).

– Fundamental changes that have occurred in the economic environment — where breakthroughs in the area of telecommunications and data processing have played a crucial role and their contribution is visible in the way financial institutions are organized and how they function. Also the emergence of new customer friendly products which are made available via new distribution channels (home and telephone banking, introduction of intelligent ATM networks).

– The market for financial services is increasingly globalized, a trend apparent on the demand and supply side alike: for institutional investors (such as investment and trust megafunds) domestic and even regional markets are becoming too small; territorial expansion — visible especially in the case of banks — has a global dimension; the ability to provide services in all the key financial markets has become the accepted practice for many commercial banks; mergers and acquisitions recorded recently are the instruments to reach this market objective.

1. The institutional structure of the Polish financial system

An efficiently operating financial system constitutes the basis for long-term economic growth. This is a commonly known statement and to repeat it might seem trivial. In an economy which is in the midst of transition to recall this statement, and — more importantly — simultaneously strive to implement it in a consistent and comprehensive manner, is a prerequisite when attempting to build up an environment which will be conducive to the implementation and subsequent efficient functioning of market economy mechanisms. The command economy produced a surrogate of a financial system, whose semblance to its counterparts operating in developed capitalist economies was reduced to a similarly sounding name. The function of money was much more limited than in market economy, both in terms of the role it played (principally reduced to that of a means of exchange) and forms in which it was encountered (excessive role of cash and poor functioning of cashless mechanisms). The institutions of the financial system, even when they were physically in place in the socialist economy, as a rule fulfilled roles which were altogether different from that which could be inferred from their misleading names. Banks were vested with the duty of administrators allocating money on the basis of political criteria which had nothing to do with credit risk assessment driven lending decisions. The interest rate was but an instrument in the process of income redistribution while its function of a driver of the price of money was totally ignored.

In the heyday of the centralist regime the National Bank of Poland was a deposit taking and lending institution, whose profile was that of a universal bank[1]. Specialized banks played a supplementary role in the Polish banking system and included Bank Gospodarki Żywnościowej, Bank Handlowy S.A. w Warszawie and Bank Polska Kasa Opieki S.A.

Some of the institutions and functions usually encountered in capital markets were totally non-existent. The stock exchange was quoted as a textbook example of capitalist chaos and the lair of punters and as such was exiled from the reality of the Polish economy. Securities — equity and debt instruments — existed in but a rudimentary form.

A financial system which could constitute the foundations of a long-term economic growth in a market economy had to be built from scratch in Poland. In the beginning of the transformation period the banking sector enjoyed a dominant status in the financial sector as such, while capital market infrastructure was totally non-existent and hence the influence which the capital markets exerted over the allocation of capital was in essence negligible. System reforms, initiated in 1989, were meant to make functioning of the banking sector more efficient and adjust it in such a manner as to ensure compatibility with the requirements of a market economy generating the will to stimulate revival of the functions of the capital market *per se* and strengthen its role in the economy as a whole.

The reforms within the National Bank of Poland which were started in 1989 resulted in the delegation of its operating activity to the newly established nine commercial banks[2] and thus — as a result of this decision — the central bank retained only the function of a national central bank, the currency issuing bank and the bankers' bank[3]. The period of economic transformation forced the implementation of far reaching changes in the way the existing specialist banks operated (this was especially visible in the following institutions: Bank Handlowy S.A. w Warszawie, Bank Polska Kasa Opieki S.A. and Bank Rozwoju Eksportu S.A.) and eventually resulted in their transformation into universal banks. In such banks as Powszwechna Kasa Oszczędności B.P. and Bank Gospodarki Żywnościowej S.A. — one of the biggest banks in terms of asset totals in Poland — far reaching and comprehensive restructuring programs are still underway. Their strategies and market shares will soon be defined.

[1] As part of the "consolidation" campaign the following banks were merged into the National Bank of Poland: Bank Rolny (Agricultural Bank) — 1947, Bank Inwestycyjny (Investment Bank) — 1965 — Polska Kasa Oszczędności (Polish Savings Bank) — 1975.

[2] They started trading as at 2 January 1989, while the separation of People's Savings Banks in the form a state-owned PKO BP Bank was effected slightly earlier — 1 January 1989.

[3] The Law of 31 January 19989 — The National Bank of Poland Act, "The Journal of Laws", 1989, item 22.

At the beginning of the 1990s the National Bank of Poland pursued quite liberal licensing policies with respect to granting permits to entities wishing to establish banks and hence it allowed for the emergence of a considerable number of private banks as well as enabling renowned foreign banks to enter the Polish banking market.

The emergence of a few dozen new private banks bolstered competition in the market but at the same time led to the weakening of stability in this market. Some of those banks were established solely to satisfy financing needs of their owners. Several of them started trading without adequate professionally executed support structures and had neither adequate human resources nor sufficient indispensable know-how to be viable. Failure to exercise due diligence in their operations was the key reason for a number of bankruptcies across the sector and some banks were acquired by others when insolvency was imminent, which led to the increased costs of the system operation.

Foreign banks in Poland have continued their market expansion drawing on tactics proven in international settings and enjoying the support of strong capital resources of their parent institutions. They pose a genuine competitive threat to other players in the sector and thus their presence contributes to increasing quality of financial services available in the market.

Similarly, the legal and institutional framework of the capital market was created from nothing into a functional system. In 1991 the Securities Commission and the Warsaw Stock Exchange were established and their operations were regulated by the Law on Public Trading in Securities and Trust Funds adopted slightly earlier. Shortly thereafter other institutions of the capital market came into being and the development of the market gained momentum.

Changes in the insurance sector occurred at a slower pace and deregulation as well as privatization processes affected a much smaller portion of the sector than was the case in the banking sector. Growth of business that followed in the insurance sector was however perceived as an incentive by many investors to branch out into that market segment. Thanks to those developments at present there are quite a number of insurance companies present in the market, including many which are privately owned and/or enjoy the benefits of foreign investors' equity involvement.

Also other segments of the financial market are enjoying a dynamic growth including leasing and factoring services.

Sustainable foundations for the operations of investment funds were created, although in this sector one can hardly identify any breakthrough which should be fueled by the reform of the social insurance system.

2. Mechanisms and the progress in harmonization of the Polish legal framework of the financial sector with the regulatory regime in force in the European Union — on the road to accession

The required scope, subject and pace of adjustment processes with respect to the financial sector legal environment are defined by "European Union Association Agreement between the Republic of Poland and European Communities and their Member States" in force since 1 February 1994. The objectives in this area are also directly driven by Poland's will to become member of the European Communities which was translated into a formal application submitted on 4 April 1994. The European Union Association Agreement mandates Poland to harmonize her current and future legislation with solutions adopted by the Communities and complete those legislative processes within 10 years. The European Agreement includes banking law and financial services among priority areas with respect to the harmonization effort (Article 69), and similar importance is also attached to the co-operation between Poland and the Union in the area of adopting a common body of regulations and standards in the field of supervisory and regulatory mechanisms in the banking sector (Article 83). The harmonization is not tantamount to replicating the legal patterns and solutions adopted in the European Communities but is meant to lead to a compatibility of legal rules applied in law making procedures, the interpretation of law and supervision over its enforcement. "The White Paper on Preparing the Associated States of Central and Eastern Europe for Integration with the Single Market of the European Union" was presented to Poland in June 1995. The document delineates legal regulations in place in the Communities with which harmonization of Polish law to the legal standards adopted in the European Union is indispensable. The paper contains an overview of the systems adopted in 23 sectors in the Single Internal Market, including financial services and free flow of capital. Hence fundamental principles, procedures and mechanisms adopted across the Single

Market for a given sector are subject to harmonization — which in case of the financial sector means efforts affecting:[4]

- banking,
- securities markets,
- insurance,
- free flow of capital.

For the purpose of the present paper it is necessary to attempt an overview of the key legal regulations and principles governing the functioning of the financial system of the European Union since those in not so distant future will be binding on Poland. The evolution of the Polish financial system should be viewed in the light of the financial law and mechanisms and institutional solutions prevalent in the European Union.

2.1. Constitution of the financial system of the European Union

Owing to its pivotal importance to the stability of the economy as a whole the financial system is considered to be a matter of public good and hence is subjected to special protection. Therefore the State adopts relevant legal regulations defining the functioning of the financial markets. In essence, minimum and clearly defined regulations are in place, their strictly mandatory status is secured and they do not in any way hinder the operation of free market mechanisms. Similarly, therefore also in the European Union the financial market is subject to regulations in some areas, which are mandatory for all Member States. At the same time Member States follow the principle of autonomy with respect to adopting country specific solutions in the areas which are not covered by the harmonization regime at the level of the European Union neither are they barred from adopting more stringent regulations as long as they are in pursuance of the objectives laid out in the directives of the Union.

The area subject to unification affects only minimum standards which are considered indispensable to ensure the stability of economic growth.

The body of regulations which are binding on all Member States is a peculiar legal vehicle which in essence is a constitution of the financial system of the Union. The harmonization of the key principles which govern the operations of the financial system of the Member States is manifested mainly in regulations pertaining to:

- institutional solutions,
- functional sub-markets,
- the extent of information disclosure.

The market for financial services in the European Union is a uniform one where each bank, insurance company or an investment fund operating in any of the Member States may without any additional limitations make its services available in any other Member State. To that end it may offer the full range of its services — as it does in its home country — in any country of the Union without the need to provide for its commercial representation or do so via own representative offices whose establishment and operations are not subject to any restrictions. The freedom to provide financial services and to establish branches of financial institutions in any Member State by entities domiciled in one of them, coupled with the commonly adopted ban on applying any unnecessary restrictions on capital flow and settlement of payments between Member States thus act as the foundation of the financial integration of the European Union.

The financial constitution of the European Union is a body of universally binding minimum legal regulations applicable to the financial system having a diverse legislative origin. Some of those date back to primary law, mainly treaties that established the European Communities and their governing bodies. Most of the them originate from secondary law created by organs of the European Community — the Council of Europe, the European Commission and the European Parliament.

2.2. Harmonization of banking law and supervisory due diligence regulations

The scope of adjustments covers the key principles of establishing, operations and supervision over lending institutions. The Membership of the European Communities requires that the central

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[4] Piontek, E. *Harmonizacja polskiego prawa bankowego z prawem Wspónoty Europejskiej. Urząd Rady Ministrów. Biuro Pełnomocnika Rządu d/s Integracji Europejskiej oraz Pomocy Zagranicznej. (The harmonization of the Polish banking law with the laws of the European Union)*, "Prawo Bankowe", Warsaw 1995, p. 22.

bank's status in each of the Member States be in compliance with the provisions of the Maastricht Treaty and By-laws of the European System of Central Banks and European Central Bank. The principal responsibility entrusted to the central bank is to provide for the stability of prices without sacrificing its independence whilst complying with a bar on financing public sector deficit.

The principal rules underlying the banking law in the European Union which currently are adopted as minimum standards valid for the Single Market for Financial Services have evolved over the period of more than 20 years[5]. The core of the EU regulations in the banking sector is defined by the provisions of the two "banking" directives: The First Banking Directive of 12 December 1977 (77/780/EEC) on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions. The Directive contains a uniform statement of principles with respect to bank licensing and introduces the principle that supervision over activities of banks is to be exercised by the country in which they are domiciled. However, it was the Directive of the Council of Europe of 15 December 1989 (referred to as the Second Banking Directive) that introduced the principles that enabled the actual functioning of the Single Market for banking services across the European Union. Those principles are as follows:

– the freedom to offer services and establish branches of banks in other Member States;
– the principle of single license, whereby the grantee of such license was authorized to be involved in the business of banking — in the scope defined by the license — in the entire EU;
– national banking system;
– national license, banking supervision, sanctions and liquidation regime;
– national deposit guarantee mechanisms;
– functional links between supervisory authorities;
– deregulation affecting the activities of the banking sector and banking supervision;
– definition of the area affected by harmonization of banking law[6].

The Second Banking Directive has in essence defined the model of a universal bank as the basis for community regulations concerning the institutional aspect of the banking system[7]. The directive contains the definition of banking operations which is considerably wider than what traditionally has been included in the range of services offered by deposit taking and lending banks. In addition to deposit taking and involvement in the business of lending the business of banking is also deemed to encompass such operations as trading in securities on own account and participation in share issues and provision of ancillary services thereto. The Second Banking Directive does not impose a model of universal banking, thus allowing leeway to business organizations to branch out into specialized banking institutions and multifunctional holding companies.

In accordance with the assumption laid out in the White Paper the adjustment processes afoot in the Polish banking law are meant to bring it line with the EU standards — and albeit underway since 1995 — still call for a plethora of further changes and require a lot of refining[8]. The legal standards set forth in the White Paper — which are subject to the harmonization effort in the European Union — have a decisive impact on the way lending institutions operate although those standards do not in a direct manner define the institutional and legal framework of the banking market in the Member States. Similarly, in Poland, they do not define the principles of banking sector operations in an unequivocal manner, instead they just delineate the scope of allowable solutions. The freedom of manoeuvre is still relatively extensive.

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[5] The first piece of legislation which affected banks was the Directive of 28 June 1973 (73/18/EEC) on lifting restrictions in licensing of banking services and on services they provide.

[6] Fojcik-Mastalska, E. *Konstytucja bankowości europejskiej (The constitution of European Banking)*, "Prawo Bankowe", 3/96, p. 95.

[7] Ibid., p. 93; Piontek, E. *Harmonizacja polskiego prawa bankowego z prawem Wspólnot Europejskich*, Urząd Rady Ministrów. Biuro Pełnomocnika Rządu d/s Integracji Europejskiej oraz Pomocy Zagranicznej, *(Harmonization of the Polish banking Law with the laws of the European Communities*, the Office of the Council of Ministers, The Office of the Government Plenipotentiary — European Integration and Foreign Aid). Warsaw 1995, p. 8 Daniluk, D., Niemierka, S. *Podstawowe limity inwestycji kapitałowych dla banków (instytucji kredytowych) w Unii Europejskiej (Principal capital investments limits for banks (lending institutions) in the European Union)*, "Prawo Bankowe" 1/96, p. 75.

[8] Piontek, E., *Harmonizacja...*, p. 112.

2.3. Harmonization of the regulations of the Polish insurance law with the regulatory framework in force in the European Union

Similarly as in the area of banking law Poland undertook to harmonize her laws regulating the insurance sector with Community standards. However, as set forth in Article 44 of the European Union Association Agreement Poland is required to open its market for foreign insurance companies and enable them to operate directly in the Polish market before the transition period is over. The provisions of Polish law pertaining to property and life insurance are in essence compatible with the letter of relevant Council directives. Unfortunately the enforcement of some provisions which are already in force is far from satisfactory. The regulations which define assets which are to be classified as shareholders' equity, the manner in which solvency ratio is calculated and its accepted threshold levels as well as those which concern the minimum value of guarantee capital, meet even the most stringent of standards applied across the European Union. This is of very little comfort, however, since many companies (including the leviathan of the Polish market PZU S.A.) — as evidenced by the audits completed by the State Insurance Supervision Office — were found to be in repeated breach of all those regulations and for years have managed to escape scot free. Following the results of inspections the State Supervisor warned those companies that appointment of state nominated administrators was imminent if they failed to increase their insurance funds and cover them with deposits. The regulations with respect to the way insurance companies are to function within the Single Internal Market are a departure from the assumptions underlying the harmonization of the regulatory framework of insurance companies. Poland has continued to adhere to her restrictive policies aimed at protecting the domestic insurance market and assumed gradual easing of those restrictions in the second stage of the 10 year transition period. The limitations affect primarily the operations of companies with foreign shareholdings. The first five year period is designed to ensure an umbrella for Polish companies which are weak in terms of capital base thus shielding them against the competitive threat posed by market entry and expansion of strong insurance companies. After 1998 yet another protective period is scheduled when discretion to issue permits to operate in the business of insurance will be left with the Ministry of Finance, which contravenes the principle of the "European Passport"[9].

2.4. Free flow of capital

One of the principal elements of the Single Internal Market is the freedom of capital and payments flow (Maastricht Treaty, Article 73b-73g). The European Union Association Agreement assumes that in the first stage (5 years) measures aimed at creating conditions necessary for facilitating a gradual introduction of regulations guaranteeing free capital flow will be implemented, focusing especially on removal of existing limitations with respect to citizenship, domicile or location where capital is invested. The regulations currently in force in Poland (Foreign Currency Law of 2 December 1996 with subsequent amendments) impose certain limitations in this respect and therefore call for further harmonization measures. The idea of spreading liberalization measures over time is justified by the concern to stabilize the fledgling capital and money markets. Since Poland has already adopted the OECD Code of Capital Flow Liberalization our regulations in this area are now much closer to those in force in the European Union.

3. Development prospects of the Polish financial system

The degree to which the Polish financial system is underdeveloped may be measured by the gap existing between its current state and the condition of financial sectors in the countries which are directly comparable to Poland in terms of the stage of economic development such as the Czech and Slovak Republics and Hungary. Also developed countries — such as Spain, Portugal or Greece — whose level of development is within the reach of Poland's economic growth ambitions can be chosen as a benchmark. When the first group of countries is reviewed the results of the comparison with Poland differ from country to country, but undoubtedly Poland is not the clear leader insofar as far as her financial sector is concerned, unlike in other areas of economic development where her leading

[9] "Council Directives", No. III, 18 June and 10 October 1992.

status is very visible. Only when comparison is made against the developed countries — classified as average performers in the European Union — is one able to see the big gap existing between our financial system and standards prevalent in those EU countries whose development level is closest to Poland's. The financial systems of the countries in whose economies transformation processes are under way vary with respect to the size and quality of operations alike, but on average all of them are relatively much smaller than in the developed countries. For the banking systems in the countries of Central and Eastern Europe the ratio of cash resources in circulation and bank deposits to GDP is half below the average for OECD countries.

In this respect the banking systems of the independent countries of the former Soviet Union are even more deficient than those in other post-communist countries and those which entered the scene after the disintegration of Yugoslavia.

There are conflicting opinions as to the degree to which the financial system contributes to economic development. Some support the stance that the financial sector plays an active role with respect to determining the pace of economic growth. When such an approach is adopted changes in the way the financial sector operates and its growth may actually outperform the growth of the economy as a whole and thus the sector may trigger economic growth. This conclusion stems from the assumption that the Keynesian model of stimulating business cycle fluctuations via monetary policy is effective in practice. A different approach — favored by monetarists — supports the idea that the financial system fulfills its role in the economy in the most effective manner when its passive adjustment to the increased production potential of the whole economy is ensured. This conjecture in turn stems from the assumption that the role of monetary policy in essence boils down to exercising care to fine tune the supply of money to long-term trends observed in the growth of GDP. The roles assigned to money and the financial system in the economy may be compared to those of law and regulations. Their good quality, stability over time and trust put in them by the public and business community alike are necessary to ensure proper functioning of the economy[10]. As economic growth gains momentum the importance of financial institutions increases owing to the growth financial assets enjoy in the bulk of societies' wealth as well as leading to gradual penetration of financial services into the realms of managing savings and assets of the public. The faults of the institutional framework may be the barrier to economic growth, while its adequate structure is undoubtedly conducive to economic upturns, one may venture to say that it acts as a peculiar kind of agent of change in this respect. The care exercised when designing a modern financial system in our country is an effort in the direction of ensuring sustainable foundations for long-term growth. Countries which embarked on transforming their command economies into market driven ones have no examples to follow with respect to the structure of transformation processes. However, the experience which developed countries have may indeed be very useful in an economic policy exerting influence over the development of the target model of the institutional framework capable of facilitating fast economic growth. Skillful imitation of those patterns will enable Poland to shorten the period that would otherwise be needed to remove the development gap.

4. Prospects of fast growth in the banking sector

The impressive growth of the Polish banking sector witnessed over the recent years is just the beginning of a long way ahead.

The projections with respect to GDP growth in the near future and removing the gap which exists between Poland and countries enjoying average standards of economic development indicate a number of prerequisites that must be met if the banking sector is to keep abreast of the growth taking place across the country's economy. The real growth in the banking sector anticipated before the year 2000 is expected to considerably outperform the real increase of GDP.

Assuming the annual GDP increase is at the level of 5% before the year 2000 and that the inflation level falls below 10% p.a. and is supported by the increase in the value of bank deposits[11] to the level of 45% the forecasted real growth of asset total for the entire banking sector will be 12% per

[10] Balcerowicz L . *Wolność i rozwój. Ekonomia wolnego rynku (Freedom and Growth. The Economics of Free Market)*, Kraków 1995, p. 241.

[11] At present this ratio for Poland is 30%, in other countries of Central Europe and the EU it is much higher — over 45%, with the exception of Hungary — 38% in 1995.

annum over the next five years[12]. Given the increasing competitive pressure in the market coming from the penetration of foreign banking and non-banking institutions Merril Lynch analysts forecast that the average increase in profits across the banking sector will be at the level of 8% until the year 2000[13].

The relative size of the banking sector which defines its strength and importance to the economy is reflected in the ratio of assets, loans, bank deposits and equity capital of the banking sector to GDP. In economies under transition also the share enjoyed by banks where the private sector has majority equity stakes in the total of the market for banking services is also an important consideration. Among the countries of Central Europe which were analyzed at the end of 1995 only in Slovakia was the share state-owned assets higher than in Poland.

Poland is a country where the ratio of the value of banking sector assets to GDP is relatively low. In Poland this ratio is at the level of 54% whilst in the Czech and Slovak Republics it is 149% and 112% respectively.

The ratio of the value of deposits held by the banking sector to GDP indicates the society's willingness to accumulate savings on the one hand and the banks' ability to attract deposits on the other. Also this comparison yields an unfavorable picture of the Polish banking system — deposits held by the banking sector constituted a meagre 30% of GDP — whilst in the Czech and Slovak Republics and in Hungary they accounted for 79%, 61% and 38% of GDP respectively.

Relative weaknesses of the capital base of the Polish banking sector are visible when the value of the ratio of shareholders' equity of Polish banks to GDP is examined against its counterparts in other countries in Central and Eastern Europe. The level of this ratio in Poland is a few times below that noted in the Czech and Slovak Republics and also significantly below that for Hungary.

The share of private in the aggregated value of shareholders' equity of the banking sector in Poland was 11% in 1995, and for the Czech and Slovak Republics and Hungary was 43%, 53% and 35% respectively.

4.1. The necessity to pursue privatization

The vision of an open and competitive market for financial services should be reflected in the target model of the Polish banking sector. The role of the state should be limited to putting in place required legal principles governing the operations of lending institutions and supervising compliance with them. In terms of ownership structure of the sector private ownership both public and institutional should prevail. Privatization is not an aim in itself. The imperative to privatize results from an assumption that market mechanism operating in an environment characterized by free competition are the most effective means to allocate resources and increase wealth. Privatization is one of the key instruments ensuring revival of the spirit of free enterprise and competition and thus contributes to improvements in the efficacy of market mechanisms. The banking sector is subject to the same rules are hence there is no reason to treat it in a different manner. The arguments supporting the need to retain special control over the sector with the State cannot be justified by any sound theoretical reasoning nor are solutions based on that assumption encountered in any of the developed capitalist economies[14].

At present in Poland banks with majority stakes still in state hands predominate in the banking sector in terms of the share they enjoy in the sector's assets, deposits held and shareholders' equity. The progress of the privatization processes in this sector is slower than in other countries of our regions.

The original program of Polish banking sector privatization envisaged fast privatization of the nine commercial banks that were hived off from the NBP but was later redesigned. In October 1995 *The Program of Privatization of Banks with State Equity Interests — until the year 2000* was adopted, and advocated the need for consolidation of wholly owned joint stock companies of the State Treasury

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12 Vergot, D., Pettyfer, S. *Polish Banks: Polishing Up Their Act,* Merril Lynch, 28 May 1996, p. 36.

13 Ibid., p. 36.

14 France may serve as an admonishing example here, when the socialist government was at the helm the banking sector was nationalized and later — when faced with the necessity to compete with private banks from other European States — embarked on the implementation of global expansion strategy. The costs of corporate recovery that had to be borne as a result of those attempts were staggering — in the case of Credit Lyonnaise alone they were to the tune of dozens of billions of dollars. Currently quick privatization is perceived as a rescue measure for this and similar French banks.

prior to their privatization. In autumn 1996 the government adopted the Strategy for Strengthening the Banking System in Poland along with the privatization program until the year 2000. They envisaged that:

– some of the "nine" commercial banks will be privatized separately i.e. Bank Kredytowy S.A. w Warszawie (slated for 1997) and Bank Zachodni S.A. we Wrocławiu;

– Accelerated privatization will affect Bank Handlowy w Warszawie S.A. and Bank Polska Kasa Opieki S.A. w Warszawie, although no schedule was communicated to date, it is expected that they will be privatized between 1997 and 1998;

– Bank Gospodarki Żywnościowej S.A. and Powszechna Kasa Oszczędności BP will be privatized at a later date.

As a result of changes discussed above significant delays occurred with respect to privatization of PBK S.A. Instead of a progress in selling the next banks from the group of "nine commercial banks" we have witnessed the consolidation of Pekao S.A. Group. Privatization plans designed for Bank Handlowy w Warszawie S.A. and Pekao S.A. envisage that only a relatively small portion of their shares will be sold to the public. The role of strategic investors is limited to purchasing of minority stakes. Despite holding a minority stake the State Treasury will have a decisive influence on management decisions in those banks for a number of years to come. The National Bank of Poland initiated efforts aimed at selling its equity interests held in commercial banks: Polski Bank Inwestycyjny S.A., PROSPER-BANK S.A. and Pierwszy Komercyjny Bank S.A. Privatization of those banks may with a high degree of certainty be expected to be finalized in 1997.

Given the present condition of the industry and juxtaposing it against the target model **the improvements in corporate governance which need to be achieved through emergence of strong and influential shareholder groups in privatized banks should be considered the overriding goal of privatization of the banking sector in Poland.**

Corporate governance is defined as the set of instruments, means and actions ensuring maximization of return on equity capital. When this goal is met it guarantees that benefits will simultaneously be derived i.e. long-term growth and competitiveness. The prerequisite for this objective to be met is **the existence of strong and independent ownership which in a competitive environment enforces high standards of management and brings about effective utilization of available resources.**

When implemented in a consistent manner privatization will generate a number of benefits for the banking system:

– improved corporate governance;

– refined standards of management across the sector;

– increased competition in the market for financial services;

– strengthened capital adequacy of individual banks and of the sector as a whole and bringing it to a level which will ensure adequate potential to cater for customer's financial needs;

– increase in the range and quality of financial services available in the market;

– emergence of conditions facilitating consolidation of the banking sector;

– removal of the sense of uncertainty permeating the sector and the growth in positive expectations attached to the prospects of state-owned banks.

The privatization of the Polish financial sector should remain the chief goal of the central government. In the event that the thrust of privatization is deliberately halted in order to satisfy ad hoc political and economic needs adverse influence of such moves will be felt across the sector and will lead to a depressed pace of economic growth.

Privatization will produce expected benefits manifested in improved standards of management, better utilization of resources and increased profitability if and only if when implemented effectively. "Formal" privatization not supported by ownership structure geared to strengthen corporate governance will not allow for the aforementioned objectives to be met. The privatization of the Polish banking sector will be effective when it secures the emergence of a strong and independent owner exercising real corporate governance. It seems that an excessive dilution of equity among a plethora of small shareholders and the absence of a dominating owner among the shareholders of banks will significantly reduce the likelihood of achieving the desired output i.e. successful restructuring of banks and adjusting them to cope with the requirements of a competitive economy. Given the specific nature of Polish conditions one can hardly expect that management teams in banks — when left to fend on their own — will be capable of tackling the developmental challenge posed by the task. Lack of proven track record in such undertakings is the main reason why they require support from a strong and independent owner having adequate experience and know-how to offer. Such an owner would be expected to ensure international competitiveness which would lay the foundations for a sustained growth of banks. There is no other alternative but to continue privatization of the banking sector in Poland. Privatization is a prerequisite for the emergence of a banking sector which whilst being effective in its macro and microeconomic performance will be competitive in international settings.

4.2. Consolidation of the banking sector

Consolidation — understood as the mix of take-overs and acquisitions structured in such a way as to lead to securing of strong market position of the entities involved — is an obvious choice for the banking sector in Poland[15]. This is as a rule justified by — *inter alia* —

– too low level of shareholders' equity to meet the financing needs of the Polish economy and face the competition coming from international banks;

– lack of banking institutions having nation-wide coverage and adequately developed network of outlets;

– excessive number of banking institutions given the actual needs of the market;

– insufficient size of individual banks making them unable to bear the burden of financing necessary investments in the development of banking technologies which are necessary to secure medium-term competitiveness;

– lack of "critical mass" adequate to the needs of the sector and necessary to enable emergence of economies of scale.

The Government decided that consolidation vehicles offered by the existing provisions of the Commercial Code and Banking Law are insufficient. As a consequence Parliament passed the Law on Consolidating and Merging Selected Banks Trading as Joint Stock Companies, which paved the way for the establishment of Pekao S.A. Group in September 1996. The Group comprises Bank Polska Kasa Opieki S.A. as the parent banks and subsidiary banks: Bank Depozytowo-Kredytowy S.A. w Lublinie, Powszechny Bank Gospodarczy S.A. w Łodzi and Pomorski Bank Kredytowy S.A. w Szczecinie.

It seems that the necessity to pool equity in the banking sector is not the key reason for consolidation in Poland. The comparison of the share enjoyed by four biggest banks in the total assets of the sector made for Poland, Central and Western Europe reveals that the equity concentration patterns in the Polish banking sector do not differ from the standards, and in many cases concentration is even higher.

The main deficiency of the Polish banking sector is relatively low capitalization. The ratio of shareholders' equity to GNP in Poland has a very low value when compared against other countries of our region and those countries of the European Union, whose level of economic development may be considered average.

The relative value of shareholders' funds of the biggest Polish banks is low in comparison to their ability to provide credit facilities to finance investment projects and comply with prudential regulations with respect to the concentration of credit risk exposure (Article 35, XX Banking Law)

The maximum amount of a single loan that Pekao S.A. group may extend is PLN 189 m which is a mere USD 67 m. Bank Śląski, the fifth bank of the country in terms of shareholders' equity — could, given its capital levels at 30 June 1996, extend a single loan not exceeding PLN 80.2 m — the equivalent of USD 28.5 m. The maximum level of exposure to one business borrower arising by virtue of all facilities and guarantees extended may be 50% higher than the figures quoted in this paragraph.

Consolidation does not by itself generate new equity. Its direct impact is manifested in pooling of existing clusters of equity. The indispensable increase in capitalization of the Polish banking sector may only be achieved through accumulation of generated profits, new share issues or acquisition of new external funding in the form of subordinated capital. Mergers and acquisitions in the Polish banking sector should in the near future result in the emergence of several universal banks having

[15] Johnson, H.J. *Bank Mergers, Acquisitions & Strategic Alliances* New York 1995, p. 4 et al. The number of US banks declined from 14,000 in 1975 to 10,592 in 1994. It is expected that continued consolidation will lead to a target number of 5,000 banks. The tide of mergers swept also European and Asian markets. The main reasons for such developments are: increased internal competition in the banking market and that triggered by the influence of other financial institutions; growing importance of capital markets as the source of funding meeting short-term financing needs of non-financial institutions (commercial papers); increased competition coming from non-financial institutions.

nation-wide coverage. Until Pekao S.A. Group was in place Poland did not have a bank that could strive to secure such a status in the sector. There only existed a number of large retail banks with nation-wide market presence such as PKO BP. Specialist banks, such as Bank Handlowy w Warszawie S.A. or BGŻ S.A. also enjoyed a large territorial coverage.

The instance of pooling resources manifested in the emergence of Pekao S.A. Group indicates that there indeed are possibilities to achieve fast increase in market share. The organization that was established after the merger in many aspects has a dominant position in the Polish banking system. The Group has 26% of all deposits held by the banking system and 19% in the total of assets.

With respect to the number of organizational units (branches, sub-branches and customer service points) the new banking institution ranks as second in the country and is considerably ahead of its competitors. As at 30 June 1996 PKO BP had the biggest number of outlets — 876, Pekao S.A. could boast 424 and BGŻ S.A. ranked third with 160 outlets. Pekao S.A. stands out in respect of even distribution of its outlets throughout the country.

The consolidation of commercial banks around Bank Polska Kasa Opieki S.A. triggered a number of major mergers. Despite the fact that the government gave up the idea of grouping a number of banking institutions under the aegis of Bank Handlowy w Warszawie S.A. a number of initiatives focused at pooling financial institutions were afoot in the market. In November 1996 PBK S.A. acquired 94% of Polski Bank Rozwoju S.A. shares. On the other hand, PBR S.A. is expected — putting the act together with Kredyt Bank S.A. and Warta S.A. — to be involved in the privatization of PBK S.A., which could facilitate the creation of a large banking and insurance conglomerate[16]. Wielkopolski Bank Kredytowy S.A. also adopted a pro-active approach and acquired two banks; Bydgoski Bank Budownictwa S.A. and Gliwicki Bank Handlowy S.A. BIG S.A. is striving to acquire Bank Gdański shares which are still in the state hands and if those efforts are successful BIG will gained full corporate governance[17]. The activity of banks manifested in mergers and acquisitions is clearly gaining momentum. As is evident from the chart below market consolidation involves domestic and foreign players alike.

In addition, 6 co-operative banks, following liquidation, were acquired by non-co-operative sector banks, another 41 co-operative banks — following the decisions of their governing bodies — chose to merge with other co-op banks, of which 10 were aided in their efforts by the NBP and two relied on support from the Banking Guarantee Fund.

In Polish conditions an expansive strategy targeted at winning bigger market shares and pivoted around mergers and take-overs may be equally successful as in international settings. When adopted it will yield benefits faster and be more cost effective and easier to implement than one based on a self-contained growth of one institution. Such expansion strategies however need to be based on professional studies and be supported by efficient management of the consolidation process, modern banking technologies enabling effective management at the operating and strategic levels alike as well as should be coupled with proven banking risk control procedures and an innovative product offer.

One should however remember that the objective of the competitive struggle does not lie in shifting balance of powers in the existing markets but is rather focused on securing a position in the expected dynamic growth of the financial markets. Therefore strategies based on building up growth from scratch may be equally effective. This concerns especially foreign banks although exemplary growth performance of such banks as Kredyt Bank S.A. and BIG S.A., which started trading at the beginning of the 1990s may be very revealing. Modern telecommunications technologies enable an increase in the availability of banking services without the accompanying need to invest in extensive network build-up. The traditional network of outlets inherited from corporate predecessors or one developed in the past may more often than not be a barrier to the development of modern retail and corporate banking. Foreign banks when entering the Polish market usually can muster advanced technologies and draw on proven procedures which ensure blitzkrieg market successes.[18]

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[16] PBK S.A. is among major shareholders of Kredyt Bank S.A. alongside Warta S.A. — the holder of 10% of equity in the bank.

[17] "Gazeta Bankowa" No. 50, p. 7, 15 December 1996.

[18] In order to boost their competitive position foreign banks drastically downsized their traditional networks in their home countries simultaneously reducing staffing levels and chose to focus on developing a technical infrastructure which boosts availability of financial services and permits lower unit costs.

4.3. Foreign capital in the Polish banking sector

The impact which foreign capital exerts on the Polish banking sector can be considered from a number of angles:

– share in the institutional structure;

– effectiveness of operations of banks with foreign capital participation;

– influence on the scale of competition in the market for banking services.

The liberalization measures targeted at removing constraints for the activity of foreign investors in the Polish market were one of the key components of the package of system reforms initiated in 1989. As the integration of the Polish economy with such international structures as OECD, the European Union and WTO progressed the range of barriers to foreign investors' entry into the financial services market has become gradually smaller. No later than upon Poland's accession to EU all barriers protecting the Polish market against foreign competition and influx of international investments will be altogether lifted. The freedom to provide financial services and to establish branches of financial institutions in any Member State by entities domiciled in one of them coupled with the commonly adopted ban on applying any unnecessary restrictions on capital flow and settlement of payments between Member States are the key elements of the financial integration of the European Union.

It should therefore be expected that soon foreign capital will have complete leeway of operations in the banking sector and in every respect will enjoy treatment of equal status with domestic capital. Independently of Poland's obligations arising by virtue of international treaties and agreements signed this target state of the economy is desirable from a purely economic point of view. The experience gathered to date clearly shows a number of positive developments triggered by the activities of foreign investors in the Polish banking sector:

– transfer of work methodology and styles which have proven effective in developed financial markets;

– the increase in the range and quality of services available in the Polish market as a result of fiercer competition stimulated by foreign institutions;

– high efficiency of foreign banks' operations became a benchmark standard when assessing the performance of Polish organizations;

– increased trust in the Polish banking sector and Polish economy visible in the international markets and manifested in the development of interbank co-operative links and better access to financial markets and inflow of foreign capital into Poland.

The inflow of foreign capital is manifested in a number of forms (i) involvement in privatization including invitations to purchase shares of banks held by the State Treasury (ii) establishment of private banks with foreign equity holdings and (iii) permits issued to foreign banks to operate in Poland. Foreign investors who were most extensively involved in the privatization processes taking place in the Polish banking sector included ING Bank N.V., Allied Irish Bank, Commerzbank and EBRD.

ING Bank and AIB now holders of majority stakes in BŚK S.A. and WBK S.A. respectively gradually built up their equity holdings starting from acquisition of minority stakes during primary public offer and later purchased additional shares from the State Treasury. Commerzbank A.G. acquired a new issue of BRE S.A. shares targeted at an institutional investor.

The share of foreign capital in the emergence of new banks was in terms of quantity of institutions involved much higher than in the sale of privatized banks. After 1989 many new banks started trading with foreign investors among promoters:

– Międzynarodowy Bank w Polsce IBP S.A. w Warszawie,

– Pierwszy Polsko-Amerykański Bank S.A. w Krakowie,

– Solidarność Chase Bank S.A. (presently GE Capital Bank S.A. w Gdańsku),

– Polsko-Amerykański Bank Hipoteczny S.A. w Warszawie,

– Bank Inicjatyw Społeczno-Ekonomicznych S.A. w Warszawie,

– Bank Wschodnio-Europejski S.A.,

– Polski Bank Rozwoju S.A.,

– Investbank S.A.,

– Bank Komunalny S.A.,.

– Bank Częstochowa S.A.

Foreign capital also increased its stake in the Polish banking sector by investing in banks with mixed ownership structures (state-owned and state and privately owned) which were already established on the Polish market. The following instances — where foreign investors acquired majority holdings — merit attention: Bank Rolno-Przemysłowy (Rabobank International Holding B.V.), Petrobank S.A. (LG Investments Holdings B.V.) and Polbank S.A. (GM Acceptance Corporation).

The forms in which foreign capital is institutionally present in the Polish banking sector are supplemented by operating activity of branches or subsidiaries of foreign banks trading pursuant to Polish law. In either case such banks are subject to NBP licensing requirements.

Currently under such legal regime 3 branches and 16 foreign banks operate in Poland.

In September 1996 out of the total of 78 commercial banks operating in the country there were 23 institutions where foreign shareholders enjoyed majority (defined as 50% of equity plus one share).

Banks where foreign capital predominates stand out in terms of better financial performance and higher growth rates than other banks in the sector. Over three years (1992-1995) their assets grew approximately 3.5 times faster than the sector average. This trend has continued until the present[19]. The effectiveness of foreign banks is high and the growth in profits, ROA and ROE is on the average higher than in other banks.

Foreign banks also stand out with respect to a high share of income generated by lending and operating business in total income[20] as well as in terms of a high share of loans in assets. Their operations were focused on the following areas:

– trade finance,

– financing of current and investment needs of large domestic and foreign private companies,

– launching new innovative products on the market,

– developing comprehensive co-operative links with large corporate customers drawing on comparative advantages stemming from international position enjoyed by their parent banks.

Foreign banks play a major role with respect to stimulating the growth in the range and quality of services offered in the Polish market. Their growing market share bolsters competition and forces positive changes in the rest of the sector. This competitive regime is the best method available to prepare Polish banks for functioning in open international financial markets and the Single Services Market of the European Union.

5. Development trends in the capital markets

The period of fast growth of the Polish capital markets undoubtedly is still yet to come. Its immense development potential should be achieved through exploring new areas of capital market activities which were hitherto non-existent in the Polish financial sector:

– the growth of pension funds and of closed-end trust funds whose basis should be created by the implementation of long-awaited reform of the social insurance system, and should be stimulated by the enactment of the new legislation regulating the operations of open and closed-end investment funds and of mixed profile investment funds;

– the development of a market for derivative instruments;

– the growth in the volume of debt securities issued by business and local government organizations to finance investments;

– the development of a regulated OTC market.

– significant growth in the market capitalization of companies listed on Warsaw Stock Exchange as a result of admission of NIF management companies and their portfolio companies and other companies' shares to public trading and new listings resulting from primary issues of state-owned enterprises and from floatations of private companies going public.

The stock exchange market has enjoyed a steady growth and the Warsaw Stock Exchange is in a continued state of flux. The introduction of continuous trading for selected stocks was the most important recent change that occurred to the WSE whilst trading in the first derivative instrument (which is likely to be linked to WIG — the official index of the Exchange) is in the pipeline. When the changes to its technical infrastructure have been completed the Warsaw Stock Exchange may for long time to come enjoy the status of the most important institution of this kind in Central Europe. Currently its total capitalization — or when measured against the value of GDP — is not imposing

[19] In the first three quarters of 1996 the increase in asset totals noted in banks where foreign capital predominated was 28.1% and when measured against September 1995 figures was 389%.

[20] According to General Banking Supervision Inspector Figures this share was 70.3% — with sector average of 53.8%.

but the Exchange outperforms its competitors in the region in terms of better liquidity and better organization of trading.

The trend manifested in hiving off brokerage houses from the organizational structures of commercial banks will not constitute the starting point for their evolution into investment banks. Those brokerage houses which currently are functioning within the biggest banks or groups of banking institutions will be the first ones to be separated out from the corporate structures of their parent organizations and will be entrusted with the mission to fulfill specialized brokerage functions as part of financial conglomerates. Most of investment banking functions will be retained with and further developed by universal commercial banks with nation-wide coverage and strong capital base.

Investment banking will be integrated with what hitherto has been widely understood corporate banking where competition forces the market players to provide comprehensive and innovative services tailored to the need of the corporate customer.

At present bank brokerage houses control the market which in itself is relatively fragmented. The consolidation of companies under the aegis of PEKAO S.A. will result in the shift in the balance of powers among the top market players. Brokerage houses representing PEKAO S.A jointly control approx. 19% of trading in securities, whilst COK BH S.A. enjoys 16% of the market, the top five houses — when their shares are aggregated — have 59% of the market.

Growing competition in the market, including that coming from foreign brokerage houses, changing profile of investors and shifts in their requirements as well as increasing equity threshold levels permitting applications for listing to the Securities Commission will rank among the key factors shaping the situation of brokerage houses.

It may therefore be expected that as a result of the combined influence of those factors the following three key categories of intermediaries will have evolved in this market:

– large bank brokerage houses offering a full range of services and capabilities (also provided in conjunction with the parent bank) — including firms organizationally separated from their parent institutions and those functioning within corporate structures of banks;

– foreign brokerage houses;

– specialist "niche" brokerage houses, bank affiliated and including firms organizationally separated from their parent institutions and those functioning within corporate structures of banks (universal medium size brokerage houses are likely to disappear from the market).

The consolidation processes in the capital market are underway. The mechanism of competition and strategies adopted by market players result in mergers of weak brokerage firms or lead to their acquisition by stronger competitors.

The increase in the share of institutional investors will influence changes in the structure of supply. Such investors expect comprehensive services which apart from brokerage include securities offer preparation and execution, underwriting and advisory assistance in the area of investment analyses and asset management. Such requirements can only be met by the biggest and best prepared brokerage firms. At the same time however many specialized small "niche" firms will continue to operate in the market.

Considerable surge in competitive pressure coming from foreign firms should also be expected. Many foreign firms have already established their presence in the Polish market —

Citibrokerage, Creditanstalt, Raiffeisen, Fleming, ING Barings to name but a few. Full opening of the Polish market to foreign competition — slated for 1 January 1999 — will accelerate the pace at which renowned foreign financial institutions are entering the Polish market. Their strengths lie in immense experience and a considerable number of big customers they have served for many years in their home countries. They will be primarily competing with large bank affiliated brokerage houses.

The increase in the number of small customers connected with the expected growth in new forms of savings instruments — trust funds — will allow smaller brokerage firms having local coverage to stay in business.

6. The outline of the target model of the Polish financial system

The Polish banking sector has dominated over the entire financial sector. Banks play the role of financial intermediaries and make capital allocation decisions. The transformation of savings into investments is taking place primarily through banking institutions. Banks also play a leading role in the process of monitoring the performance of businesses and vastly contribute to corporate recovery processes. At the same time the process of privatization through sale and the Mass Privatization

Program were significant thrusts contributing to the evolution of the capital market into a vehicle of capital allocation whose dominating role is characteristic of the Anglo-American financial systems, where the transformation of savings into investments and monitoring of corporates are handled by the capital market institutions.

The discussion of the target model of the financial system in Poland should — where possible — draw on the experiences of economies where the share of capital market is dominating as well as incorporate positive aspects of systems pivoted around banking institutions. Nevertheless the following factors play a crucial when making a decision what kind of a financial system should be selected as a target model:

– situation at the outset (the current state of the financial system);

– solutions most frequently encountered in economic and political structures membership in which is the strategic objective of our country.

Banking law currently in force as well as planned changes in its provisions allow one to assume that the Polish banking system will be developing toward the standard of universal banking adopted in the European Union. This model provides for the legal possibility of combining deposit taking and lending activity of banks with their participation in the public trading in securities and the business of insurance. The germs of banking and insurance groups of companies are already there in the Polish market[21]. The consolidation in the banking sector and the integration of the insurance market will considerably fuel this trend.

The financial sector is expected to provide support to the transformation, restructuring and development processes taking place in the Polish economy. Given the insufficient development of non banking forms of short and medium term lending (capital markets for debt instruments, investment, trust and pension funds) the banking sector is expected — at least for some time to come — to continue to be the main source of accessing external funding to finance investments[22] and development in the manufacturing industries. Banks will also in the near future dominate in the market of services targeted at the consumer market[23]. The banking sector may support transformation, restructuring and development efforts thus acting as the financial backbone and source of economic innovations. In order to meet such challenges the system itself must be transformed and the manner in which it operates must be aligned with the requirements of the market economy so that it is capable of becoming highly competitive. To that end structured and consistent efforts aimed at privatizing banks which are still in state hands are needed as well as liberalization of foreign capital access to the Polish market is required.

The capital market is the best vehicle to ensure optimum allocation of capital and implement effective corporate governance and monitoring of corporate's performance. The development of the financial system when based on the operations of universal banks does not preclude the situation where the capital markets play a bigger role than nowadays. Taking heed of the processes involving the convergence of hitherto existing systems which are now afoot in the developed economies stimulating the development of the capital market merits special attention. This concerns both securities markets and the emergence of a group of strong investment, trust and pension funds as well as venture capital providers.

The number of changes which are still ahead of the insurance sector and necessary to supplement the financial sector conducive to nourishing long-term economic growth is by far the biggest. A more detailed analysis of this issue is beyond the scope of the present paper. Irrespective of that, however, it should be clearly stated that privatization of the biggest insurance undertakings — which are still in the state hands — when based on principles similar to those applied upon privatization of the banking sector should soon result in the improvements in the standing of insurers and the sector as a whole. Should the quasi-monopolistic situation in the insurance sector persist — with PZU S.A. and PZU Life having a ruthless grip on the market — harmful effects are imminent

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[21] Polish banks are major shareholders in Polish insurance companies.

[22] In Western Europe and Japan the role of commercial banks as the source of capital necessary to fund development has steadily decreased. In the US the capital markets for debt instruments (bonds, commercial papers and convertible stocks) have traditionally been the chief source of external capital. In the recent years in Poland strong enterprises have financed growth through increases in equity capital at the same sacrificing rate of return on equity. Financing of investments and growth on the basis of external funds (debt capital) for some time to come will in Poland continue to draw on bank lending and/or share issues purchased mainly by banks.

[23] In Western countries non-banking or quasi-banking institutions are currently a serious competitor to retail banking services offered by banks. At present in Poland an adequate range of services offered by banks but on the other hand also there are no strong non-banking institutions which could oust them from this segment in the near future.

and the possibility for the emergence of private insurance undertakings which are string enough and well prepared to compete at an equal footing with foreign insurers will be destroyed.

Tables and graphs

Table 1
Institutional structure of the Polish financial sector

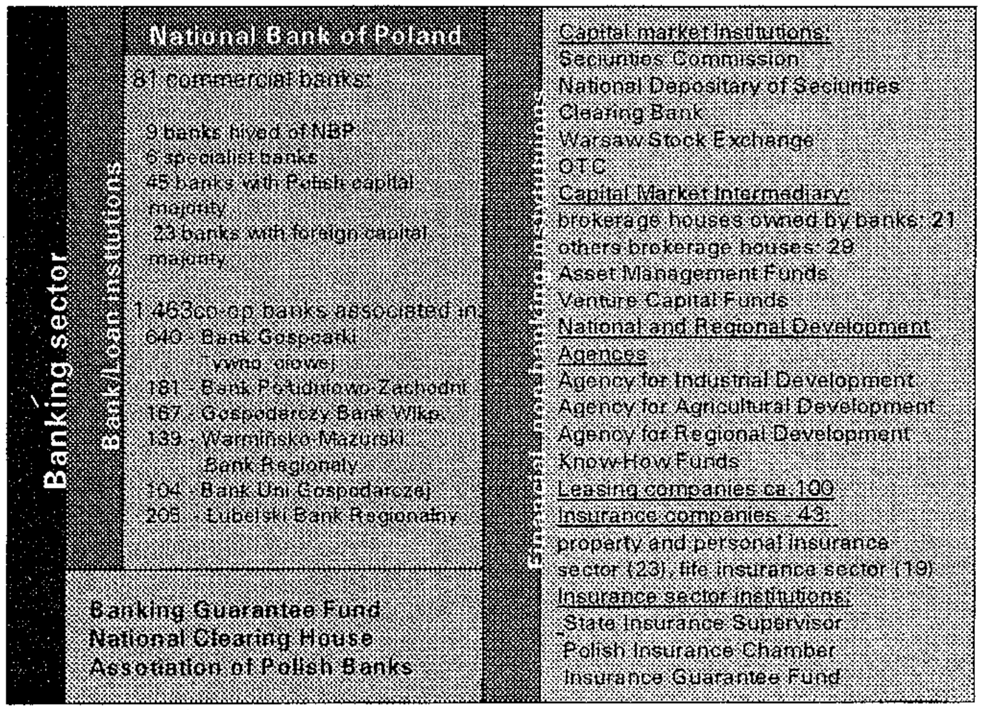


Table 2
The share of banks with different structures of shareholdings in the assets of the banking sector in the countries of Central Europe (1991-1995) and GNP

	Czech Republic		Slovak Republic		Hungary		Poland	
	1991	1995	1991	1995	1991	1995	1991	1995
As %								
State majority *	94	17	97	65	90	27	95	56
State minority with blocking **	0	52	0	15	5	49	1	14
State minority without blocking ***	0	52	0	8	3	28	0	4,5
Private	6	31	2	20	5	24	4	30
TOTAL	100	100	100	100	100	100	100	100
As % GDP								
State majority *	140	27	91	72,5	70	19	48	30
State minority with blocking **	0	82	0	17	4	34	0	8
State minority without blocking ***	0	81	0	8,5	2	19,5	0	2
Private	9,5	48	2	23	4	16	2	16
TOTAL	149	157	93	112	78	69	50	54

* State majority means the stake equal to at least 50% of equity + 1 share.
** State minority enabling blocking of strategic decisions.
*** State minority.
Source: Author's studies on the basis of Borish, M.S.; Ding,W.; Noel,M.: *On the Road to EU Accession. Financial Sector Development in Central Europe*, World Bank, Washington D.C. 1996, pp. 7-15.

Table 3

The share of banks with different structures of shareholding in the deposits held by the banking sector in the countries of Central Europe (1991-1995) as % GDP

	Czech Republic		Slovak Republic		Hungary		Poland	
	1991	1995	1991	1995	1991	1995	1991	1995
As %								
State majority *	97	10	96	73	87	23	97	72
State minority with blocking **	0	68	1	10	6	61	1	16
State minority without blocking ***	0	68	0	5	3	44	1	5
Private	3	21	3	17	7	17	1	12
TOTAL	100	100	100	100	100	100	100	100
As % GDP								
State majority *	59	8	51,5	45	35	8,5	25	21
State minority with blocking **	0	54	0	6	2	23	0	5
State minority without blocking ***	0	53,5	0	3	1	17	0	1
Private	2	17	2	10	3	6	2	3
TOTAL	61	79	54	61	41	38	26	30

* State majority means the stake equal to at least 50% of equity + 1 share.
** State minority enabling blocking of strategic decisions.
*** State minority.
Source: Author's studies on the basis of Borish, M.S.; Ding,W.; Noel,M.: *On the Road to EU Accession. Financial Sector Development in Central Europe*, World Bank, Washington D.C. 1996, pp. 7-15.

Table 4

The share of banks with different structures of shareholding in own funds of the banking sector in the countries of Central Europe (1991-1995) as % GDP

	Czech Republic		Slovak Republic		Hungary		Poland	
	1991	1995	1991	1995	1991	1995	1991	1995
As %								
State majority *	91	25	92	38	81	25	94	62
State minority with blocking **	0	31	3	9	8	40	1	27
State minority without blocking ***	0	31	0	5	5	15	1	8
Private	9	43	5	53	11	35	4	11
TOTAL	100	100	100	100	100	100	100	100
as % GDP								
State majority *	6	4	5	5	5	1	5	2
State minority with blocking **	0	6	0	1	0,5	2	0	1
State minority without blocking ***	0	5,5	0	1	0	1	0	0
Private	0,5	8	0	7	1	2	0	0
TOTAL	6	18	5	13	6	5	5	3

* State majority means the stake equal to at least 50% of equity + 1 share.
** State minority enabling blocking of strategic decisions.
*** State minority.
Source: Author's studies on the basis of Borish, M.S.; Ding, W.; Noel, M.: *On the Road to EU Accession. Financial Sector Development in Central Europe*, World Bank, Washington D.C. 1996, pp. 7-15.

Table 5
Banks privatized since 1992

Bank	When privatized	Share in aggregated assets of the banking sector
Bank Rozowju Eksportu S.A.	1992	1.6%
Wielkopolski Bank Kredytowy S.A.	1993	2.7%
Bank Śląski S.A.	1993	4.2%
Bank Przemysłowo-Handlowy S.A.	1995	4.2%
Bank Gdański S.A.	1995	2.5%
Total		**15.2%**

Source: author's own calculations, end of 1995 figures.

Table 6
Major mergers and acquisition deals in the banking sector — January-September 1996

Acquiring bank	Acquired bank	Equity stake held
Kredyt Bank S.A	Bank Regionalny S.A. w Rybniku	take-over*
Bank Zachodni S.A.	Bank Rozwoju Rolnictwa ROLBANK	take-over
Rabobank International Holding B.V	Bank Rolno-Przemysłowy S.A.	51%
General Motors Acceptance Corporation	POLBANK S.A	68%
K.A. International Partnership L.P.	Bank Komunalny S.A.	5,8%
BWR	BWR REAL BANK S.A.	51%
CIAL S.A. Bank France	BISE	8,7%
Allied Irish Bank European Investments Limited	WBK S.A.	36,3%
ING Bank N.V	Bank Śląski S.A.	54,1%
Kredyt Bank S.A.	Bank Depozytowo-Powierniczy GLOB	take-over
WBK S.A.	Bydgoski Bank Budownictwa S.A.	take-over
WBK S.A.	Gliwicki Bank Handlowy S.A.	85,3%
Bank Rozwoju Eksportu	Bank Energetyki S.A	26,2%
Bank Inicjatyw Społeczno-Ekonomicznych S.A.	Bank Świętokrzyski	20,4%
PBG S.A.	Spółdzielczy Bank Ludowy w Łodzi	take-over

* Take-over through merger.
Source: GINB.

Table 7
Strategic investors in major Polish commercial banks

Name of Polish commercial bank	Strategic investor	Share in vote
Bank Śląski S.A.	ING Bank	54,08%
BRE S.A.	Commerzbank AG	21,00%
BPH S.A.	EBOR	15,06%
BPH S.A.	ING Bank	12,60%
BPH S.A.	Bank Śląski S.A.	n/a
WBK S.A.	Allied Irish Bank	36,26%
WBK S.A.	EBOR	23,88%
Bank Gdański S.A.	BIG S.A. Group*	31,00%
PBG S.A.	Pekao S.A.	100,00%
PBKS S.A.	Pekao S.A.	100,00%
BDK S.A.	Pekao S.A.	100,00%
PBR S.A.	PBK S.A.	32,94%
Kredyt Bank S.A.	Kredietbank NV	6,80%
Kredyt Bank S.A.	Warta S.A.	6,70%
Kredyt Bank S.A.	PBK S.A.	5,20%
Petrobank S.A.	LG Investments	50,00%

* BIG S.A Group.: Bel-Leasing S.A., FORIN S.A., BIG S.A.
Source: "Parkiet", 3.01.1997.

Table 8
Equity stakes in listed banks held by insurance companies

Name	Shareholder	% equity held
BIG S.A.	PZU S.A. i PZU Życie S.A.	17
Kredyt Bank S.A.	PZU S.A. i PZU Życie S.A.	7,50
Kredyt Bank S.A.	TUiR Warta S.A.	6,70

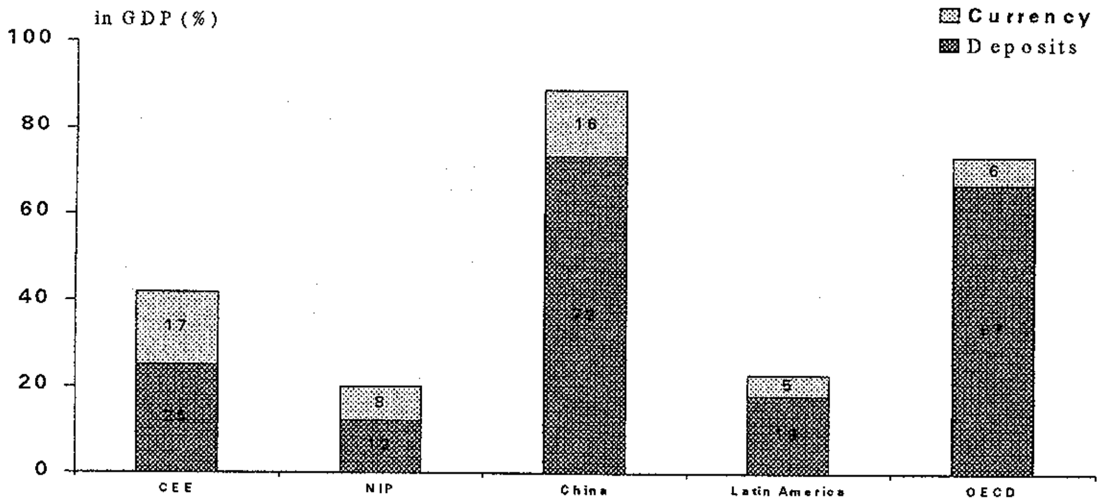
Source: "Parkiet", 3.01.1997.

Table 9
Shares in Polish insurance companies held by banks

Name	Category	Name of bank	% equity held
TU Allianz BGŻ Polska S.A.	II	BGŻ S.A.	49
BTUiR "Heros" S.A.	II	PBG S.A.	41
BTUiR "Heros" S.A.	II	Kredyt Bank S.A.	26
BTUiR "Heros" S.A.	II	EBOiR	15
TU Amplico S.A.	II	Bank Pekao S.A.	45
TU PBK S.A.	II	PBK S.A.	100
TU Energoasekuracja S.A.	II	BEN S.A.	17
TU Azur S.A.	II	EBOiR	35
TU STU S.A.	II	Bank Wschodnio — Europejski S.A.	64
TU Commercial Union na Życie S.A.	I	WBK S.A.	10
TU Amplico Life S.A.	I	Bank Pekao S.A.	45
BTUiR "Heros Life" SA	I	Pierwszy Bank Komercyjny S.A. w Lublinie	22
TU PBK Życie S.A.	I	PBK S.A.	100
TU Warta Vita S.A.	I	PKO BP	35
TU Warta Vita S.A.	I	PBR S.A.	6
TU Azur Życie S.A.	I	EBOiR	35
TU Azur Życie S.A.	I	Bank Gdański S.A.	11

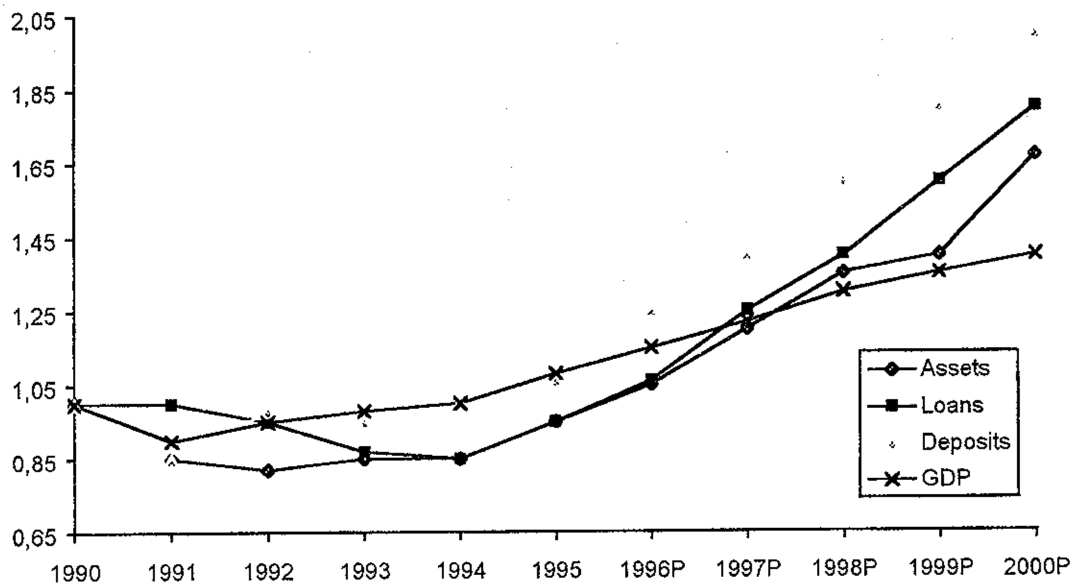
Source: "Rzeczpospolita", 4.03.1996; Author's own calculations, as at 30.06.1996.

Graph 1
Banking systems of countries in the midst of transition — circulation of money



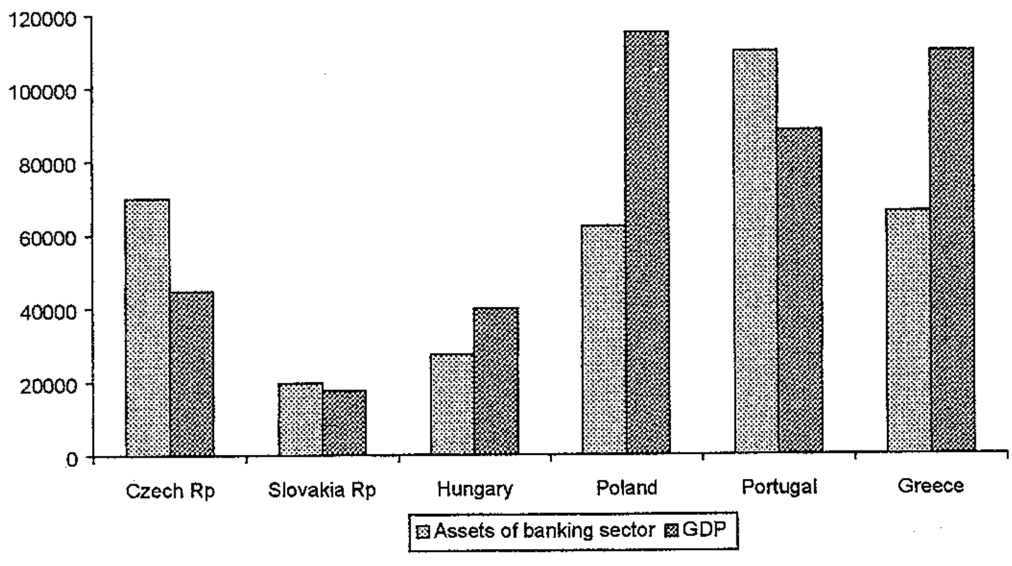
Note: the average computed for 1994.
Source: IMF and World Bank staff estimates.

Graph 2
Real growth of the Polish banking sector in comparison to GDP (1990-2000P)



P — Projections.
Source: NBP, Merrill Lynch Research.

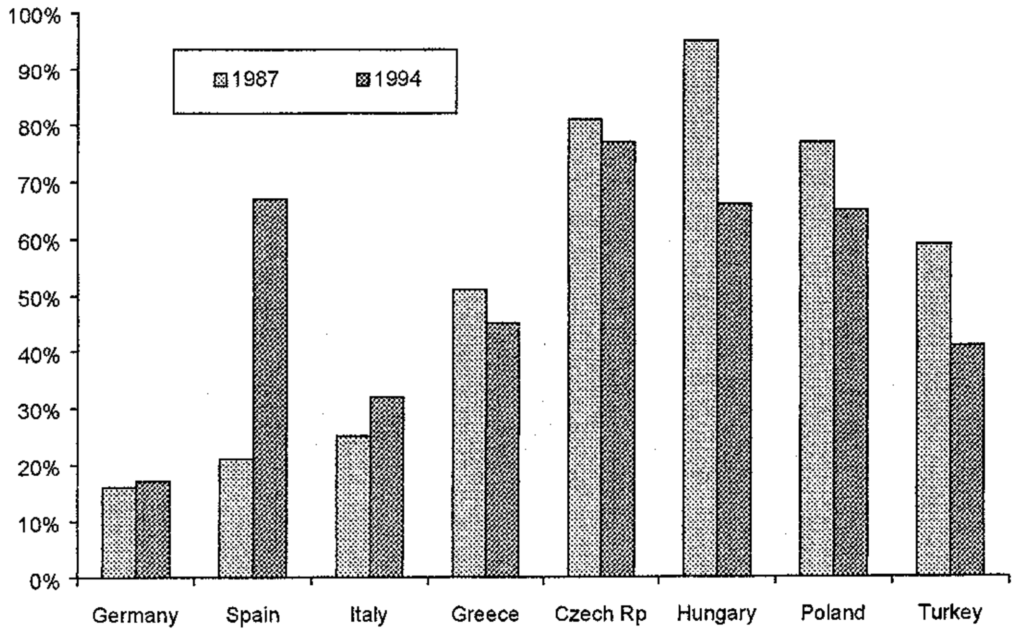
Graph 3
Assets of banking systems in selected European Countries — 1995



Source: Author's own calculations

Graph 4

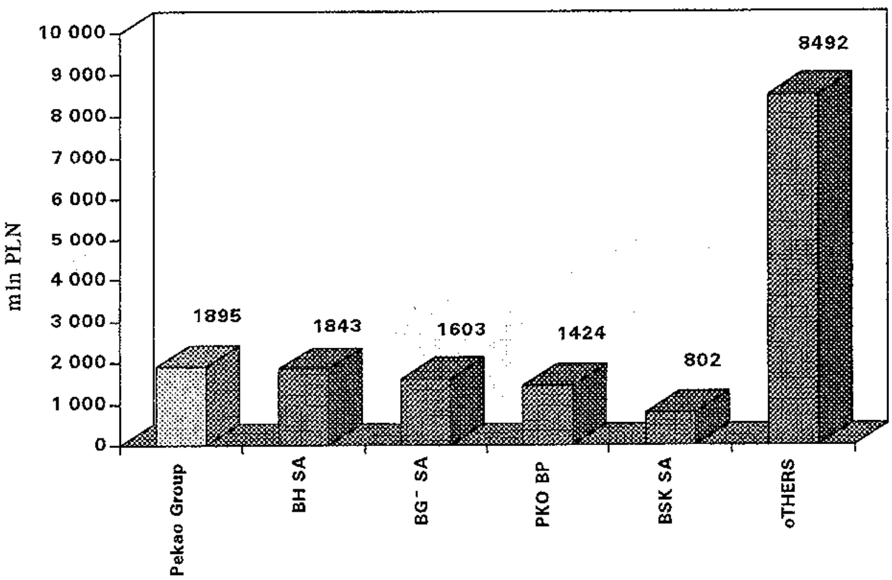
The share of 4 biggest banks in net assets of the banking sector



Source: Merrill Lynch studies.

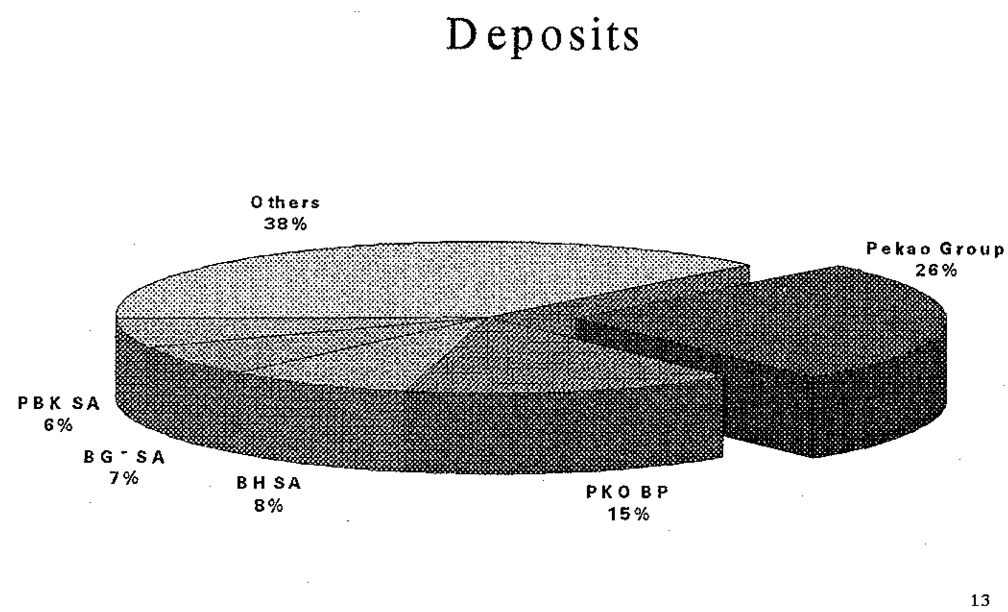
Graph 5

The major players in the Polish banking sector — shareholders' equity

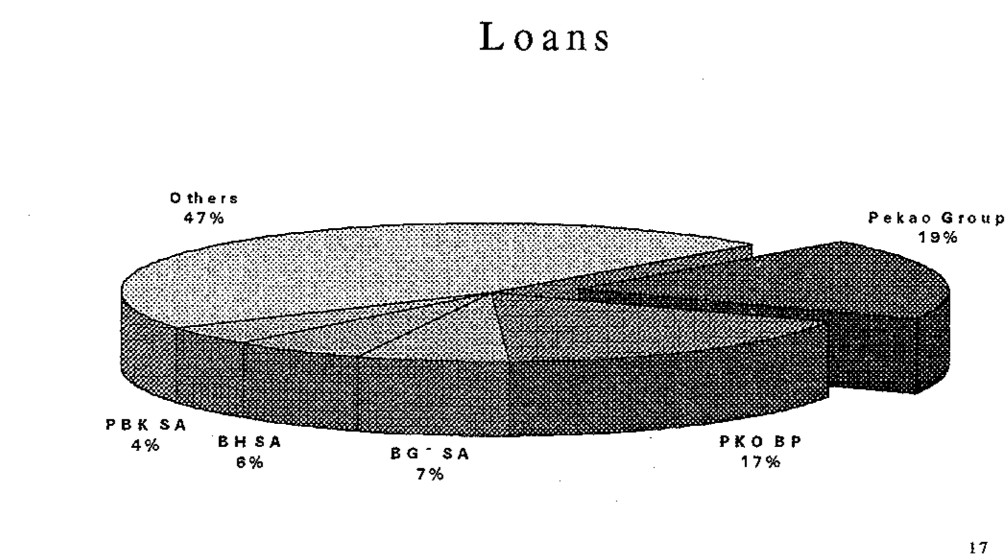


Source: author's own calculations, as at 30.06.1996 r.

Graph 6
Major players in the Polish banking sector — deposits

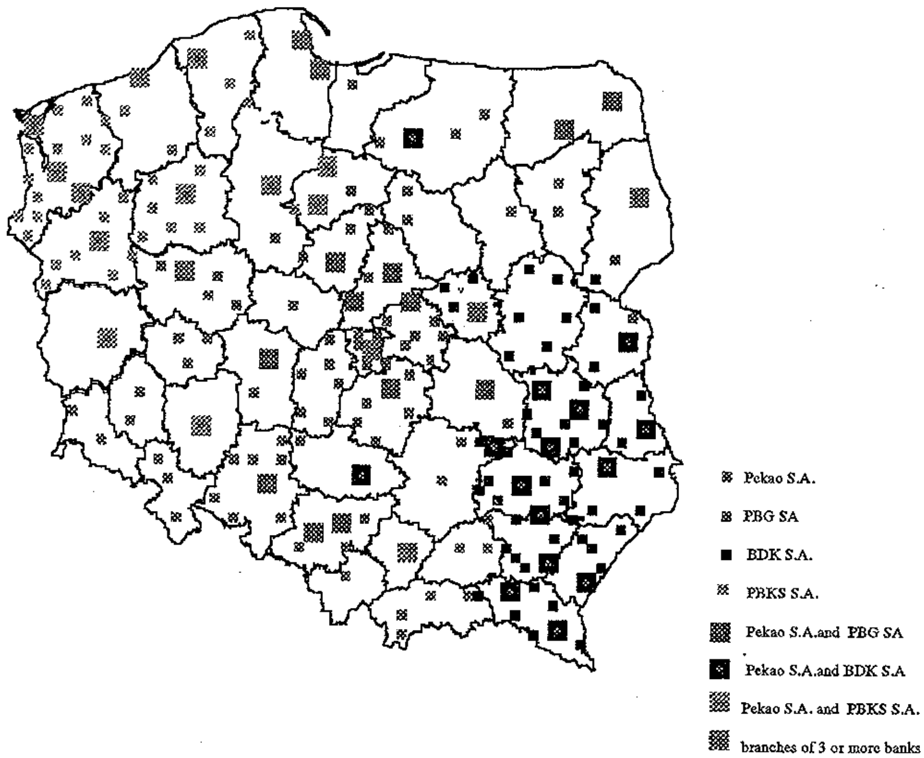


Graph 7
Major players in the Polish banking sector — loans



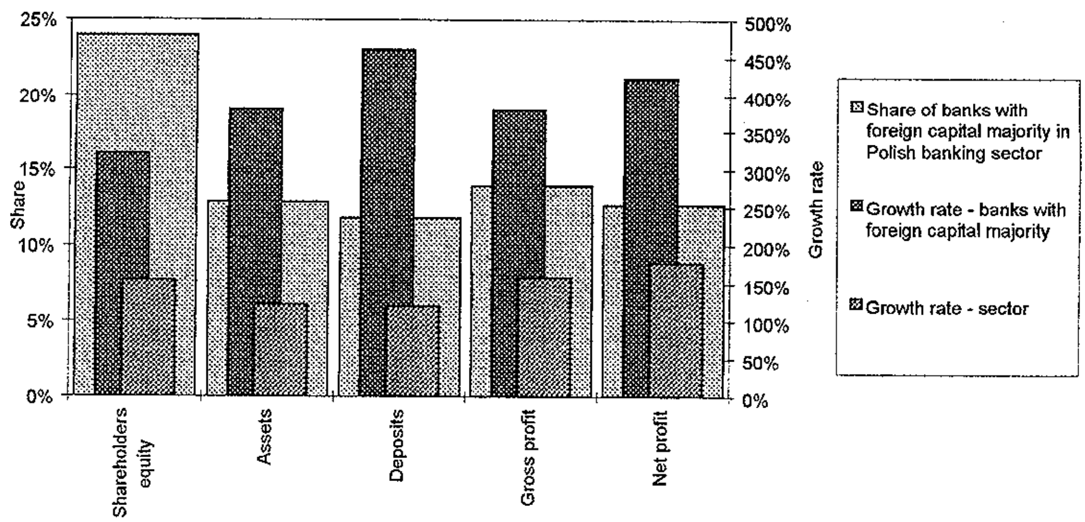
Source: author's own calculations, as at 30 June 1996.

Graph 7
The network of branches — Pekao S.A., PBG S.A., BDK S.A., and PBKS S.A.



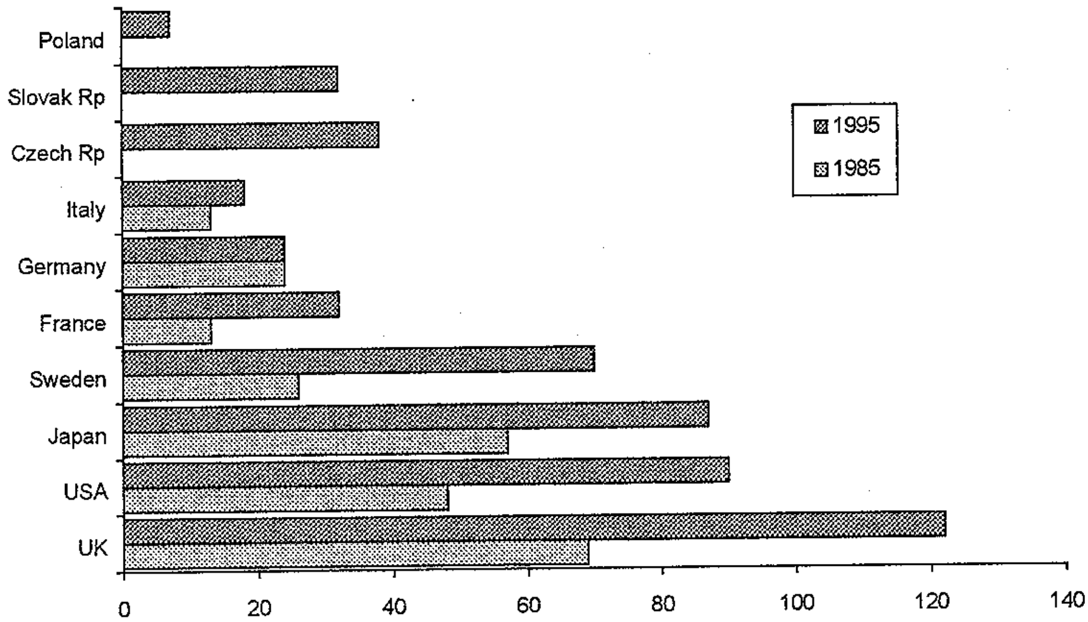
Source: author's own research, as at 30 June 1996.

Graph 8
The share of banks with majority stakes held by foreign investors in the Polish banking sector



Share in the sector, as at 30 September 1996.
Growth rate in %, December 1995 = 100%.
Source: GINB.

Graph 9
The capitalization of stock exchanges in relation to GDP 1995/1985



Source: Kleinwort Benson.

Graph 10
Share of the biggest brokerage houses in the volume of business on the Warsaw Stock Exchange