Speech by Marek Belka, President, Narodowy Bank Polski
"Building Market Economies in Europe.
Lessons and Challenges after 25 years of Transition"
24 October 2014

Ladies and Gentlemen, Dear Colleagues,

Last August, Tony Barber published in the "Financial Times"[1] an article about the events marking the beginning of the political and economic transition in Central and Eastern Europe. And I agree wholeheartedly with what Mr. Barber wrote there: "*If someone had predicted to me at the start of 1989 that all these events would come to pass, I would have been tempted to ask what they were smoking*". It was indeed a turning point in our history – 25 years ago it became possible for Poland and its neighbours to start building democracy and a market economy.

At today's conference we will speak about why and how it was possible for this to happen. We will also try to find out what lessons from the transition can be drawn for the future.

It is clear to me that what the "economies in transition" share, is the aim: to catch up with the living standards of the advanced market economies. Notwithstanding this common objective, the experience of the transition countries in the region has varied. As Robert Merton Solow, said in 1991: "There is not some glorious theoretical synthesis of capitalism that you can write down in a book and follow. You have to grope your way." After the fall of the Soviet bloc, countries from Central and Easter Europe have been designing and constructing from the ground up their own market economies, remaining under influence of an unique set of factors of an economic, political and social nature.

I would like to refer today to the factors that, in my opinion, were important for the Polish transformation, namely: **the economic strategy, the political determination, and finally, the people.**

Let's start with the strategy.

1. Strategy

First of all I would like to underline the importance of having a clear strategy. In Poland, in 1989, the first democratically-elected government faced the challenge of designing a strategy leading to the creation of a market economy. The obstacles to achieving this aim, inherited from the communist past, were huge: a severe crisis of public finance overburdened with subsides, inflation bordering on hyperinflation, shortages of goods, an enormous foreign debt, a collapsing balance of payments and low productivity.

The Polish government decided to implement a strategy of rapid and comprehensive reforms, later recognized as the so-called "shock therapy". Its advocates argued that, in order to establish normal market conditions and restart economic growth, reforms composed of three

[1] Tony Barber, *Poland's past points to the future of its neighbours*, Financial Times, 19 sierpnia 2014 r.

essential elements – price liberalization, stabilization and privatization had to be undertaken as quickly as possible. The programme incorporating strategy based on these 3 elements was launched in January 1990. It was a tough austerity programme. There were adverse results at first: inflation of over 100 per cent during the first two months of implementation, a drop in production and consumption and – slightly later – a rise in unemployment, which remained very high for years.

But first positive results appeared relatively soon. They included the elimination of demand-driven inflation, equilibration of the market, promotion of exports and stimulation of private entrepreneurship. The initial rapid internal changes helped to activate the determinants of long-term development, including those of an external character. In this regard, the activation of trade played a major role in reinvigorating the economy.

One of the core elements of the success of the Polish transition during the last 25 years has also been a relatively stable and consistent economic policy. With changing economic reality, **monetary policy** had to evolve rapidly and build up its credibility at the same time. And it did. Gradual liberalization of the exchange rate policy took the Polish zloty all the way from a fixed peg, through a crawling corridor, towards the free-float. The responsible way of conducting this process stabilized the macroeconomic environment and developed the shock-absorbing capacity of the zloty, which was successfully tested with the crisis in late 2008. One of the signs of stability provided by the economic policy has been lower inflation volatility than in most peer countries. Also **fiscal policy** was generally more prudent than in other transition economies. No major imbalances have been allowed to accumulate. Secured by the constitutional provision, public debt to GDP ratio has never exceeded 60%, while private indebtedness has also been kept sustainable which can also be attributed to the traditional and conservative banking sector. And the current account deficit has never become excessive.

Institution building and structural reforms carried out in the 90s were perhaps less spectacular than the macrostabilisation *big-bang*, but were implemented in a consistent way. Step-by-step we adopted anti-monopoly policy, established the stock exchange and introduced a variety of privatization schemes. We made some mistakes, but they were corrected in a pragmatic way. One example – in the early 90s a number of state-own and private commercial banks faced a solvency crisis, cost by a large share of non-performing loans that were not paid back by inviolable companies. For the state own banks the government helped with rehabilitation and recapitalization – they were recapitalized with long-term treasury bonds so that they could ride of bad loans. They were able to clean up their credit portfolio, which was necessary to prepare them for privatization. In mid 90s incentives to attract foreign direct investments began to bring positive results. All in all, by the end of the 90s we managed to set up the solid institutional foundations for future gains from our increasingly open and competitive economy.

2. Political dimension of an economic transition

In democratic systems politicians are in the hands of the voters. In order not to lose public support they usually prefer to speak about bright future than about painful transition strategies.

But sometimes, with regard to fundamental policy goals, an agreement between parties can be reached. Let me mention the two most important forces that united Poland to support the pains of transition.

Firstly, I have to mention the creation of the Solidarity movement and the events of 1989: the Round Table negotiations that led to the first partially democratic elections. The people were delighted with the new democracy and besides, there was nothing to look back and long for in the past. The Poles were reunited and looking to the future. Bad experience of command economy helped in a sense, politically, to gain the support.

Second thing is the power of the European integration process. For Poland, the aim of becoming a member of the European Union was of great importance. It meant re-unification of Europe and return to European democratic values. Ultimately it is to lead to better living standards. Over those 25 years all political forces shared and supported the idea of the EU membership. And this provided for continuity in macroeconomic policy – we change prime ministers, we changed finances ministers even more frequently, but the policy was broadly continued.

3. The people

I don't have in mind here people like Lech Wałęsa, Vaclav Havel, Jegor Gajdar, Leszek Balcerowicz, Aleksander Kwaśniewski or Tadeusz Mazowiecki. No doubt, they were indispensable. But I have in mind the people as a society Polish society had two important features that constituted the core of transition: "innate" support for democracy and capitalist traditions.

Poland has democratic traditions that date back to the Middle Ages, at least this is what we like to say. But, true, there was no problem in convincing Poles to become democrats and to live in democracy.

With regard to capitalist traditions – they dated from before the World War II, so there were many points of reference in the process of building structures of free market in the early 1990s. Commercial laws could have been adopted on the basis of Polish pre-World War II laws. Moreover, in Poland there was a vibrant "shadow economy", even in command economy, under communist rules, we had relatively skilled and entrepreneurial workforce. And 10 per cent of the non-agricultural GDP was created in that "private initiative" as we used to called it – shadow or semi-shadow economy. So these were strong pillars of economic and political development throughout, or at least at the beginning of those 25 years.

Ladies and Gentlemen,

I hope you agree with me now that a well-designed economic strategy, supported by the politicians and by the society is the key element of transition. However, you will also agree with Winston Churchill's words. He said: "*However beautiful the strategy, you should occasionally look at the results*". Let me therefore look at the results in a nutshell.

Between 1991 and 2013 GDP per capita increased from 32 to 62 per cent of the EU-15 average. It now stands at almost 70% of the EU-28 average.

Moreover, the last 25 years have seen a major structural shift in the Polish economy. Back in 1990, 28% of the working population was employed in agriculture. This share has decreased by half so far. Services gained importance in absorbing the labour force, increasing its share from 36 to almost 60% of total employment. Massive adjustments have also taken place in Poland's formerly overgrown industrial sector.

Private sector in Poland employs more than 75% of the working population, up from 50% in 1990. This share is higher than in France, the Netherlands or the Nordic countries. Private enterprises are particularly successful in exploring new export markets and competing in an international environment. What stands behind the success? Stable macroeconomic environment; persistent restructuring and finally, Poland's attractiveness to foreign investors. This stems, in particular, from the well-educated labour force, low labour costs and rather high labour market flexibility, both in terms of employment and wages.

Of course I need to mention the expansion of exports. While most Western European countries have been losing their market shares in world exports, Poland has doubled it over the last two decades. What is especially worth emphasizing is the increasing technology content of exports: high- and medium-technology intensive exports account for almost half of its total value. As a matter of fact, this doubling of export share of Poland in the world market is entirely due to increase in competitiveness – we are trading with less dynamic regions then on average, so it's not the case that we export especially to the rising stars of the world economy. Secondly, we trade in rather traditional or low growing goods and services so this does not carry us forward neither – it' the competitiveness. So we have carved out a bigger share in the global markets due entirely to our increased competitiveness.

Having reached the status of an upper-middle income country, a new overriding objective is to progress to the top class. We aspire to the status of an advanced economy. In essence, it means that our challenge is to switch from the growth model based on capital accumulation and lower labour costs, towards an innovation-driven one. According to the World Bank and IMF studies, the main obstacles on this way are an inefficient institutional setup combined with unfavourable demographics and low human capital, which leads to a low level of innovation in the economy. So, this can lead some people in Poland to say – well, 25 years have been a huge success, but we are in a corner – what comes next? We don't know. How to bring about this next step of advancement from a relatively high-income country to an advanced economy stage? This is a problem.

Usually we say how much we have to do to improve the environment for innovation. And we – properly – lament about the low level of public services, legal framework that is not propitious for innovation and risk taking, I fully agree. But on the other hand we know that innovation is a painful process – it's much easier not to innovate, to replicate rather than innovate. And to be stimulated to innovate, your life shouldn't be too easy. Is the life of Polish entrepreneurs so difficult as they say, as we sometimes agree with this? I beg to differ. Poland has a fantastic, splendid economic location for doing business. Poland has low taxation and undervalued złoty. Poland has a big, popular tolerance for interpreting laws in favour of entrepreneurs, even if we see difficulties and even if we see cases to the contrary. But isn't it so that in such a propitious environment the need to innovate is reduced? Just think about it.

The other great challenge for further growth is related to demographic changes.

Dear Colleagues,

I'm not going to continue to this introductory remarks, leaving the floor to David Lipton, who was a participant of this early heroic stage of reforms in the early 90s or late 80s, even. He can share with you his personal experience and personal remarks about how Poland has changed to his knowledge, how the whole region has changed. We know that we have achieved a lot, we know that it's a lot to be done and the second part is maybe even more difficult. But we have a good meeting with very competent experienced people to try to draw lessons for the future from our past successes.

Thank you very much.