Polish firms: Private Vices Public Virtues

by

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1 Polish problem as an effective demand problem.

In their interesting article about the economic dilemmas facing the polish economy on Zycie Gospodarcze [ZG] n. 8, Herer and Sadowski ask themselves what can induce polish enterprises to produce more goods. M. Misiak on ZG n. 15 indirectly gives an answer telling us why such incentives are lacking: the government always asks itself what to do when the inflation rate will fall down, and never asks itself what to do if the fall in industrial production will go on.

On the economic polish press a debate developed on the effectiveness of post July economic policies; someone advanced the idea that the pursued reflationary policy had only inflationary effects, and did not stimulate production (the more outstanding supporter of this thesis was the former Finance vice-minister Marek Dambrowski).

A cursory inspection of statistical data shows that from July to October the fall of industrial production -measured by the monthly index (see Informacja Statystyczna [IS] 8/1/91, Part I)- has been almost halved, and investment activity showed a slight recovery; then the mentioned thesis that demand impulses are working, in polish conditions, only downwards, is unsound. The point is that the outcomes were correspondent to the given impulses: i.e. reflationary measures have been too weak and pursued for too a short time, and so was the recovery.

If it were true that the mechanism of effective demand acts only downwards and not upwards, being able of only fostering inflation and not of giving real impulses to the economy, which is the Dambroski's dogma, it would be impossible to give any positive reply to the question advanced by Herer and Sadowski.

Thanks to the mentioned dogma, the crucial Misiak point cannot be taken into consideration in spite of the fact that the repeated optimism of the government revealed to be only wishful thinking. The fall of production and GNP in 1990 has been much greater than forecasted. The government forecasts on 1991 spoke about an increase in industrial production of 4% in 1991; on the contrary the industrial production fell 4% in the first quarter of 1991, compared to the
first quarter of 1990, and of 34%, compared to the first quarter of 1989. Moreover, while the fall of light production goes on, the heavy sector production, that last year was less hit by the depression, is crumbling (only recently - in a report presented in Warsaw by the Planning Minister, on April the 27th, the former forecasts have been revised downwards recording a decrease of 6% both in industrial production and in GNP).

This state of affairs raises the question what such an optimism was based on. The budget and monetary policy is ever restrictive; inflation is fed by administrative increases and amplified by the self-protective behaviour of all economic agents (and not only of so called monopolistic firms); consumer demand is lacking (according to the Market and Consumption Institute [Instytut Rynku i Konsumpcji] of Katowice, most of the families share the opinion that their shrinking savings cannot counterbalance the continuous fall in real income).

The trade between the former CMEA countries is crumbling due to the switch to hard currency regulations; export to western countries is hampered first, by the incoming recession in OECD countries, second, by the fact that devaluation gains have been fully eroded (as reported by M.Misiak polish firms think that at this exchange rate level export is no more profitable, and IMF explicitly requires Poland to maintain such a level in spite of the appearance of a trade deficit in the first quarter of this year).

Foreign firms are rather interested in making polish firm work on subcontracting in order to exploit the wage differential than to invest directly (see the Salomon Brothers statement, Wall Street Journal, April 26/27 1991). The uncertainty on the expected sales together with the monetary restrictions make investment incentives for domestic firms very weak.

In such an environment is hard to see the conditions for thriving private enterprises, which on the contrary are more hit by bankruptcies (as the Ministry of Industry, Mr. Zawislak, has recently put it: "The invisible hand is taking out the wrong firms; the best companies, not the worst ones are being ruined" Financial Times April 27/28 1991).
It is impossible that polish policy makers don’t see this situation, and it is even more unthinkable that this kind of recession suits them. The only possible explanation of their strange behaviour is that they use the wrong glasses.

2 An historical detour.

The theory underlying the stabilization plan is based on the I.M.F doctrines, subscribed by polish policy makers. This theory - as noticed by Mikolajczyk on ZG. n. 5, commenting on Kolodko’s book - has as its main target the solvency of a debtor country. The vision underlying IMF doctrine is that the state of insolvency - revealing itself in inefficiencies and imbalances - is due to a state of disorder of the economic body that can be eliminated only by a severe and prolonged therapy.

This indeed is not quite a new idea. Its roots can be traced back to the ’liquidation theory’ of the Great Depression, whose outstanding exponents were Robbins, Hayek and Schumpeter ([1]); its more explicit formulation was given by the Secretary of the Treasury, Mellon, quoted in President Hoover Memoirs ([2]):

"Liquidate labor, liquidate stocks, liquidate the farmers...It will purge the rottenness out of the system...People will work harder, live a moral life. Values will be adjusted and enterprising people will pick up the wrecks from less competent people".

According to Schumpeter the liquidation of investment whose production did not fit demand or was technological obsolete releases factors of production from unprofitable uses; they can be redeployed in other sectors of the technologically dynamic economy; but without the initial liquidation the redeployment cannot take place. In his own words:

"Depressions are not simply evils...but...something which has to be done, namely, adjustment to...change... most of what would be effective in remedying a depression would be equally effective in preventing this adjustment"(Schumpeter, 1934).
Robbins’ diagnosis was that the world economy in the 1930’s needed more, not less deflation: "In the present depression we eschew the sharp purge. We prefer the lingering disease". And Hayek, rejecting expansionary policies wrote:

"...the great expectations attached to...public works in time of depression [are]...fallacious", (Hayek, 1931).

That theory was appealing insofar it seemed reasonable: the facts proved it to be simply false. U.S. economic authorities, stubbornly following these advices, led the country to the catastrophe. Only after Keynes attack to the dogma of the market as a self-regulating mechanism, it was understood that the level of global demand has to be controlled by state intervention; then the remedies to depression could be found.

What is the linkage between these apparently old fashioned stories and the to day IMF advices on the economic policy that has to be implemented in the present polish economic situation?

The target of the 'liquidation’ theorists was reallocation, via destruction of excess and distorted capacity, built by the wrong decisions of enterpreneurs. This is he same main target of the policies that IMF advised to all countries which needed readjustment, and it is hardly questionable that for IMF the ways to reach such a result are the same of old liquidationists.

It must be recognized that IMF is quite neutral in requiring the implementation of these policies irrespective of all kind of specificities: historical and geographical peculiarities, levels of income, capital endowments, social structure and even socio-political framework (i.e. whether a country be already a market economy or be a planned one on the way of transformation).

Outcomes of IMF policies are highly controversial, and hotly debated; but leaving this discussion aside, we want to stress a further point.

In the 1930’s speaking of liquidation of excess capacity meant elimination of 'excess’ capitalists, leaving room to the stronger ones; the analogy with what to day is advocated for the polish economy is striking if we substitute plans decisions to private investment decisions. But
insofar in to day Poland all the state entreprise may be considered as responsible of the overall
distorsion of the industrial structure a dangerous conclusion *per absurdum* can be drawn: that
ture adjustment cannot start unless all the roots of distorsion (i.e. state entreprises) are elimineted.

We all agree on the necessity of a general 'privatisation' of the former CPE's; but the
road to privatisation is very long and difficult (see the Sachs and Lipton (1991) excellent appraishal
of the polish problems in privatizing the state sector). The temptation of shortening the way
may be appealing: instead of waiting the effects of a step by step privatisation the main job could
be performed by depression via bankrupcies, in such a way creating the room for private initiative
more quickly (the case of East Germany shows on the contrary how the mixture of economic
errors -i.e. establishing the exchange rate one to one- and of ideological prejudices -i.e. the will
of cancelling in one shot the whole legacy of the past- can led to a disaster).

These are the roots, even unconscious via fear of inflation, of the lasting refusal of facing
the question advanced by Marek Misiak: what have we to do if production goes on falling?

3 State entreprises: private vice public virtues.

When the stabilization plan for the polish economy was launched, many economists
advanced the opinion -against the optimistic forecasts of J.Sachs and others- that the conse-
quences of the stabilization plan would have been a drastic fall in production and a massive
unemployment ((3)).

Surprisingly enough, on a keynesian basis, while the first part of the pessimistic forecast
has been confirmed, the second has not. This discrepancy, or better its reason and its conse-
quences, is in our opinion the crucial starting point in order to understand what happened in the
polish economy.

Taking into account the monthly production index (with December 1989=100), we see
that after the initial fall of abot 30% a period of recovery took place goes from July to October,
followed by a further decrease reaching in December the January level, while the employment of the industrial socialized sector fell from December 1989 to December 1990 of 15.6% (see IS 8/1/91, Part I).

The word which has been most widely used in the comments on the outcomes of the polish stabilization plan is **overshooting**, meaning that the government economic measures have gone wide of the mark, in terms of the obtained results.

This thesis goes more or less in this way: state enterprises have risen their prices above the equilibrium level, thanks to their monopoly position, cutting the real wages, and feeding the inflation process. Had the polish enterprises behaved in a competitive manner, changing the product mix and entering new markets, the price rise would have been lower, with a smaller cut in real wages, with a consequently minor fall of output and unemployment. The decrease in production, according to this interpretation, is due to the role of price maker of polish industrial enterprises and to a bit of overshooting by the government monetary and fiscal policy ([4]).

On the contrary we think that polish recession has been caused mainly by the action of three major deflationary impulses: the cut in real wages, the fall in investments, the reduction in the budget expenditure together with the increase in taxation.

This tremendous cut in autonomous demand put in motion a process of a contraction of real income, according to a keynesian multiplier process; the peculiarity of polish recession has been that this process has been **hampered** by the employment policies of polish state enterprises, has can be seen from the fact that the initial fall in production has not be followed by a contraction cumulative process ([5]).

As far as polish enterprises are concerned we do share the recent Sachs’ opinion ([6]) that the degree of their monopolistic strength has been overestimated; furthermore, and even more important, we think that this approach overlooks the deflationary consequences of the supposed **virtuous** behaviour of polish state firms.
It seems to us that polish firms acted rather in a 'traditional' way than in a 'monopolistic' one; i.e. they didn't take into account an ex-ante trade-off between prices and quantities but rather, following their standard behaviour of price formation -of cost-plus type- they simply reacted (as would have done, more or less, the real and not textbook market firms) to a turbulent environment of rising costs, keeping in the short period their mark-up substantially constant. Indeed we can observe that the industrial sectors hit more by the demand fall -i.e. consumer sectors- have recorded a drastic fall in their ex-post profitability (see IS 8/1/91, Part I, tab. 37).

Furthermore many commentators have pointed to the 'survival' and not 'maximizing' behaviour of entreprises (see Chilosi (1990), Kolodko (1990), Winiecki (1990)) as the main cause of the failure of government measures, because they didn't react in a 'flexible' way to the new market conditions. In a situation of deep recession product-mix variations are forcibly marginal; then the only 'flexibility' open to entreprises would have been the shedding of labour. **Had they acted in the advocated 'flexible' way the multiplier would have fully acted, and the recession would have been much deeper.**

Acting their own way polish firms have been income stabilizers, stopping the recession spyral that government policies would have provoked, if non counteracted by these unusual income stabilizers.

Obviously the unemployment overhang (which has substituted the monetary overhang) has only been moved onwards, and this constitutes an impending problem for the polish economy, but all in all precious time would have been gained in order to revert the situation with a new economic policy.

On the contrary the polish governement didn't pick up this opportunity; after a brief period of softening the tight wage and monetary policy -the so called korekta, which took place in the period Summer-Autumn of the past year- economic authorities quickly reverted to the old policy.
4 Summing up

Let's come back to the question advanced by Herer and Sadowski: what can induce polish enterprises to produce more goods?

We tried to show that the main obstacle to an answer is the doctrine shaping the stabilization plan. Polish government hastily stopped reflationary measures obsessed by fear of resurgent inflation.

The reduction of the inflation rate has been one of the major economic targets of the government. If we look at the period from the beginning of the stabilization plan up to now, we can observe an inflationary floor of 3%-4% monthly. If we measure from the January hyperinflationary level it may considered a good result, but if we look back to spontaneous 1989 inflation level, before the first liberalization shock, then the real gain of the wage and monetary restrictions has been to push the inflation rate from the '89 level back the '88 level: a 6% inflation gain has been payed by a 25% fall in production; an exceptionally high trade-off. The real structural change in the inflationary process is that before the first liberalization shock, inflation was generated by an excess demand impulse, amplified by a cost-price spyral, built-in after the '82 economic reforms. After the dampening of hyperinflation by means of wage and monetary restrictions, the inflation floor is now almost totally determined by a cost-price spyral.

It cannot be denied the existence of a pressing inflationary problem and that hyperinflation, released by the liberalization shock, could be stopped in a short time, only by drastic monetary restriction. But nevertheless we think that I.M.F target of an yearly rate of inflation equal to the Great Britain's one, seems to us quite unrealistic. To get out from a command economy, albeit slightly reformed as Poland, represents such a complete upheaval of the existing economic and social structure that inflation cannot be eliminated in a short period, and furthermore cannot be eliminated with monetary instruments.
The monetary instrument usually tends to kill two birds: prices and production; given the extremely high trade-off between the two, in order to reduce inflation to the target level, it would be necessary to tighten monetary policy even more and for a too long period, shrinking production at unsustainable levels.

Perhaps it might be necessary to learn to live with these processes, controlling them, keeping the economic and social machine moving. It seems wiser to try to stabilize inflation at a minimum level, through social agreements, as suggested among others by Tadeusz Kowalik, agreements which should encompass not only dependent workers but also the rural world. A more palatable trade-off may be between a low constant inflation rate and rising production, rather than the one between a near zero inflation rate and crumbling production.

The second point we have risen is that till now Polish firms have been improper income stabilizers; it's undoubtedly necessary that they begin shedding labour force more rapidly in order to gain efficiency and competitiveness, but doing so they will release the deflationary overhang which up to now they have absorbed.

All the people who advocate an accelerated privatization in order to solve efficiency problems, forget that the first act of a private owner will be to cut drastically employment - as so many examples have shown - and hence releasing more rapidly than state enterprises all the deflationary overhang.

Against this immediate negative effect, many oppose the beneficial long period effects; to these people we reply, paraphrasing the well known Keynes' sentence, that in order to enjoy the long period benefits, it's necessary to get there alive; insisted deflationary policies not only depress the current production levels, but also the expectations of future recovery, damping investments and the perspectives of productive capacity renewal and expansion.
The stabilization plan philosophy implies a strange switch of roles: the government economic policy takes care of firms efficiency through restrictive policies, while firms are supposed to take care of the growth of production, thanks to the advocated flexibility (new products, new market and so on).

In our opinion things run the other way round; the roles must be reverted: the government must take care of the growth of production, while firms have to take care of efficiency.

The point is that only a temporary mild recession may constitute a stimulus, but not a deep depression. Only in an expansionary context the firms may abandon their concern for employment, and may try to find new business opportunities introducing new and more efficient economic techniques.

Abandoning inflation and surplus (or even balanced) budget obsessions it's high time that economic policy regains its proper role of regulating the overall level of economic activity. What is needed is a determinate reflationary policy, centered on strong investments incentives, and on a global industrial policy of restructuring the polish economy, which is not a task that can be left only to privatization or to foreign investment.

To pursue further the enacted economic policy threatens to transform the foreseeable long recession of the polish economy in a lasting stagnation.
Endnotes


Materiali di discussione

24. Fernando Vianello [1987] "Effective Demand and the Rate of Profits: Some Thoughts on Marx,
Kalecki and Sraffa", pp. 41.


40. Leonardo Paggi [1988] "Americanismo e riformismo. La socialdemocrazia europea nell'economia mondiale aperta" pp. 120.


44. Carlo Alberto Magni [1989] "Reputazione e credibilità di una minaccia in un gioco bargaining" pp. 56.


48. Roberto Golinelli [1989] "Note sulla struttura e sull'impiego dei modelli macroeconometrici"
pp. 21.


52. Paolo Silvestri [1989] “Il bilancio dello stato” pp. 34


55. Paolo Silvestri [1990] “Sull’autonomia finanziaria delle Università” pp. 11


64. Mario Forni [1990] “Incertezza, informazione e mercati assicurativi: una rassegna” pp. 37


70. Margherita Russo [1990] “Cambiamento tecnico e distretto industriale: una verifica empirica” pp. 115


74. Enrico Giovannetti [1990] “Illusioni ottiche negli andamenti delle grandezze distributive: la scala
mobile e l’“appiattimento” delle retribuzioni in una ricerca” pp. 120


77. Antonietta Bassetti e Costanza Torricelli [1990] “Il portafoglio ottimo come soluzione di un gioco bargaining” pp. 15

78. Antonietta Bassetti e Costanza Torricelli [1990] “Una riqualificazione dell’approccio bargaining alla selezioni di portafoglio” pp. 4


80. Francesca Bergamini [1991] “Alcune considerazioni sulle soluzioni di un gioco bargaining” pp. 21
