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11 March 1980

MEMORANDUM FOR THE RECC

SUBJECT: Overview of the Polish Economy [redacted]

1. The attached paper was sent to Charles Meissner, Deputy Assistant Secretary, Department of State. [redacted]

2. The paper reviews recent Polish economic performance and assesses outlook for the future. [redacted]

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Chief, U/EE

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Overview of the Polish Economy

Economy Stalls in 1979

Polish economic performance -- as measured by movement in key aggregates -- reached a post-World War II nadir in 1979. Real gross national product declined by at least 1 percent from the previous year; industrial production increased by only 1 percent. A five-million ton decline in the grain harvest to only 17 million tons led to a fall of 2 percent in overall agricultural output. [redacted]

These results translated into a dismal year for Poland's already dissatisfied population. Sales of many consumer goods including textiles, refrigerators, and automobiles fell because of production shortfalls, while the poor harvest gave rise to shortages of many fruits and vegetables. The 6-percent rise in meat sales reflected distress slaughtering in the winter of 1979 that will depress meat consumption in the future. Housing completions were 1 percent lower in 1979, mainly because of shortages in construction materials. [redacted]

Consumers were also bedeviled by accelerated inflation. The regime officially increased prices on some goods -- such as gasoline -- and permitted more "hidden" price increases by such methods as repackaging old products under new names and opening commercial stores that sell meat and dairy products at much higher prices than state stores. Unsanctioned

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Key Polish Economic Indicators [redacted]

	Percentage Rates of Growth			
	GNP	Industrial Production	Agriculture	Current Account Deficit (million US$)
Average, 1965-70	3.8	6.4	-1.1	130
Average, 1971-75	6.5	7.6	1.1	1,213
Average, 1976-78	3.2	4.2	2.1	2,849
1976	4.1	4.5	1.8	3,205
1977	2.8	4.7	0.3	2,493
1978	2.7	3.4	3.9	2,848
Preliminary 1979	-1.0	1.0	-2.0	2,995

[redacted]

price increases have also become more frequent. Official Polish statistics reported a 6.7 percent increase in 1979; the actual rate probably was as much as 15 percent. [redacted]

Despite the decline in overall economic activity, Poland made little progress in improving its external financial position. Because of the need to increase grain imports, Poland only slightly reduced its total hard currency trade deficit -- to $1.8 billion. The current account deficit ($3.0 billion) was up somewhat from the 1978 level because of rising interest payments. Poland's net hard currency debt continued to mount, to $20.1 billion by end 1979 compared with about $1 billion at end 1970. [redacted]

Reasons for Downturn

Wretched weather and deliberate policy decisions contributed to last year's unprecedented GNP decline. Agriculture was particularly hard hit by one of the worst winters on record and subsequent weather disturbances -- excess rain in spring and drought in summer. The inclement winter weather also disrupted the non-agricultural economy, primarily by causing breakdowns in transportation and electric power generation. [redacted]

Though it clearly did not desire a drop in GNP, the regime, as part of a stabilization effort dating from 1976, was striving to slow economic growth last year, primarily

[redacted]

through a reduction in investment that amounted to 8 percent. The objective of restraint was to restore external financial equilibrium by curtailing imports and freeing resources for production of exports. [redacted]

Poland's economic performance last year cannot be explained away, however, as mainly the product of (a) bad luck and (b) the necessity for sharp but temporary restrictions on output. The cumulative effect of unwise resource allocation decisions in the past and long-term, deep-seated systemic shortcomings had a greater role. Agriculture, for example, even with a return of normal weather, must still contend with chronic shortages of basic agricultural machinery and supplies, mismanagement of agricultural price policies, and the uneconomically small size of Polish farms. Furthermore, transportation and electric power will remain problem areas, reflecting a long history of inadequate maintenance, insufficient investment, and poor planning that has failed to coordinate the functioning of these sectors with the rest of the economy. To generalize, Poland's major chronic problems include:

--Mismanagement of all levels of the economic hierarchy, especially of labor and energy resources.

--A poorly motivated work force, largely as a consequence of acute shortages of consumer supplies, an

[redacted]

accelerating rate of inflation, and stagnation of wages.

--The "crisis" atmosphere pervading economic planning, which places emphasis on solving immediate problems often at the expense of longer term considerations. For instance, Poland is relying on expensive, short-term borrowing to meet its debt repayment obligations.

--The consequences of poor investment decisions in the early 1970s, when Warsaw initiated a number of marginal industrial projects at the expense of the development of important sectors such as transportation, coal, and electric power generation. [redacted]

<u>What the Government Hopes to Do</u>

Both the 1980 Plan and the 1981-85 Five-Year Plan indicate that the regime (a) intends to keep a tight rein on the expansion of economic activity but (b) remains extremely reluctant to alter the system in ways that would increase efficiency appreciably. [redacted]

Belt tightening remains the watch word for 1980. The plan calls for an increase in national income (according to the Polish concept, essentially GNP minus services) of only 1.4 percent -- half the rate of increase originally projected in the 1979 plan. Investment cutbacks again lie at the heart of the restrictive program. Another 8-percent reduction is stipulated, with temporary reductions scheduled in such critical sectors as agriculture and food processing. Within the pared-down total, investment is to be concentrated on the energy and transport sectors, housing, facilities due to be commissioned in 1980, and projects considered vital to modernizing the economy. Even with the cut back in investment, Polish consumers face further austerity, as plans to limit the rise in real wages to 1 percent suggest. [redacted]

No changes in price policy are contemplated. Official prices on staple products will be kept down to avoid consumer discontent and to protect the real incomes of lower-paid workers. Budget policy will continue to stress stable food prices through subsidies, which will account for one-fourth of budget expenditures in 1980 -- about twice the share in 1975. Nonetheless, no diminution in the rate of inflation is likely. First, the regime is unlikely to contain the rise in money wages that have become the rule, since efforts to do so conflict with attempts to buy domestic tranquility. Furthermore, to remove some of the excess demand in the markets for consumer goods, the regime will continue to permit hidden price increases. [redacted]

Indeed, Warsaw will continue to promote a degree of inflation -- albeit surreptitiously -- through expansion of special stores that sell consumer goods at elevated prices. Special clothing stores will be opened in 1980 and will operate on an experimental basis with greater freedom with respect to sources of supply, employment, and wages. In addition, a network of private stores selling meat at high free market prices has been put into operation on an experimental basis. With the associated objective of attracting citizens' holdings of foreign exchange, the government will expand sales through the foreign currency shops (Pewex), despite resentment by citizens who do not have access to hard currency. [redacted]

The 1981-85 plan implies some relaxation of austerity, with national income (Polish definition) scheduled to grow about 3 percent a year. However, this is well below the 7-percent rate the Poles had projected at the start of the current Five-Year Plan period (1976). The emphasis on continued reallocation of resources from domestic use to bolster exports is implicit in the apparent intent to further reduce the proportion of investment in national income. Investment will continue to be shifted to sectors largely responsible for shortages and bottlenecks -- energy, raw materials, and transportation. Energy conservation is

[redacted]

to be stressed, and new less energy intensive technology is to be developed. [redacted]

Although more modest than past plans, the 1981-85 goals still depend on enhanced efficiency -- as the leadership itself has stressed. This, in turn, would require substantial systemic reform. Although pressure from provincial leaders, party moderates, economists, and Western creditors will keep the reform issue alive, the regime's words and actions at the recent Party congress suggest strongly that sweeping changes over the next few years have, at least for now, been ruled out. The personnel changes announced at the Congress did not install champions of reform in key posts. Signaling a go-slow approach, Gierek indicated that if stabilization efforts and the gradual introduction of improvements in managing the economy succeed in alleviating some of the most pressing economic problems, it may be possible to consider wider reforms by 1983. Another party leader, Wladyslaw Kruczek, echoed this theme after the Congress. He explained that on the basis of an evaluation in 1980 of the present system of planning and management, a comprehensive program for improving the performance of the economy should be worked out and implemented by 1983. The leadership appears reluctant to repeat its experience with the reforms introduced in 1973, when the economy was already overheating and was suffering from the pressure of excess demand. At that time, the regime had implemented several measures including a new management system (i.e., the "system of large economic organizations" or W.O.C.), a new method for determining wages, several new success indicators, and other measures to improve efficiency and the role of prices. When the reforms did not accomplish the goals set by the authorities -- in part because they were implemented only partially -- the regime abandoned many of the reform measures and reimposed tight central controls. [redacted]

Outlook

The hard times recently experienced by the Polish economy are likely to grow even harsher -- even without a recurrence of a misfortune such as the 1978-79 winter. The prospects for Poland's righting its balance of payments without prolonged, and probably politically unacceptable, stagnation in economic growth and living standards are not bright. Indeed, a group of Polish economists, in a controversial and unofficial forecast, recently predicted zero economic growth through the 1980s and declining real personal income in Poland for the next five years. [redacted]

Clearly, a very slow rate of economic growth is the best the Poles can hope for. With investment still declining and likely to level off or rise only slowly in 1981-85, the capital stock will increase at sharply reduced rates. Furthermore, a slowdown in the growth of the working age population is under way. With percentage increments to fixed capital and the labor force declining to little more than half the levels of 1976-80, Poland must rely heavily on increased efficiency to support economic growth. [redacted]

The gloomy outlook in part reflects economic circumstances beyond Poland's control. Although still a net exporter of energy (thanks to its large coal output), Poland must import oil and natural gas, and the energy terms of trade are turning against Poland. Oil and gas prices are rising faster than coal prices. Furthermore, the USSR, which now provides about 80 percent of Poland's oil on more favorable terms than those offered by non-Communist suppliers, is unlikely to increase oil deliveries after 1980 and is likely to stiffen the terms on the oil it continues to sell. [redacted]

Poland's efforts to cut or eliminate its trade deficit vis-a-vis the West will be further complicated if, as seems likely, Western economic activity -- and thus import demand -- remains sluggish, Western trade restrictions are not significantly eased, and Polish goods (other than raw and semi-finished items such as coal, copper, sulfur, and silver) remain only marginally competitive in Western markets. [redacted]

[redacted]

Compounding the problem created by an increasingly uninviting external environment is Poland's evident reluctance, discussed in preceding sections, to overhaul its economic system. Warsaw's unwillingness to do so is a function partly of the conservative nature of the leadership and partly of its fear of a volatile population that has in the past violently protested against measures that adversely affected its living standards. The riots triggered by price rises in 1970 and 1976 are the most notable cases in point and do much to explain the furtive, timid, piecemeal approach the regime has adopted in raising prices. [redacted]

Finally, the austerity measures themselves can conflict with efforts to improve the balance of payments. Cutting imports is likely to make production for export more difficult. Reducing investment in turn hampers the expansion and modernization of productive capacity required to meet both domestic and export demand and to make Polish goods competitive. At the same time, slower growth in consumption runs the danger of demoralizing workers and thus defeating efforts to raise labor productivity. [redacted]

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