European University Institute

DEPARTMENT OF HISTORY AND CIVILIZATION

Foreign debt, crisis management, systemic transformation. Poland 1989-1994

Franciszek Tyszka

Thesis submitted for assessment with a view to obtaining the degree of Doctor of History and Civilization of the European University Institute

Florence, 29 May 2019

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Franciszek Tyszka

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Abstract

This thesis examines the role of foreign debt in the origin, progress and completion of an economic reform in Poland lasting from 1989 until 1994. The correlations between foreign debt and radical economic reform are analyzed from the perspective of the International Monetary Fund, which, since 1989, played an ever increasing role in the shaping of economic policy in Poland. This was possible thanks to a remarkable progress in the democratization process in Poland, and the role of the IMF increased proportionally with the diminishing role of the Communist Party. However, even before the formation of the democratic government of Tadeusz Mazowiecki the Fund recognized the close connection between radical solutions to both problems: the economic crisis and the debt crisis. Regardless of the nature of this correlation (political or economic one), it turned out that the Polish foreign debt problem could be resolved permanently only by introducing a historically unique economic reform. From then on, the correlation between debt reduction and systemic transformation formed the consensus on economic policies across party-lines.

I try to prove that what made this consensus possible was the inherently political nature of the debt crisis in Poland, and a resulting very strong dependency of Poland's economic development on 'political will' of Western governments. Since 1982, foreign debt was being used as a very effective instrument of Western governments' pressure on Poland. Consequently, foreign debt should be considered either a constraint to or an opportunity for a radical economic reform, depending on the period: before, during or after 1989. 'Before' - when geopolitical factors both prevented the Communists from carrying out their program of economic reconstruction, and, simultaneously, contributed to a substantial deterioration of Poland's payment capacity throughout the 1980s; 'during' – when the IMF was the first to acknowledge the great importance foreign debt could possibly have in forcing through a radical reform; and 'after' - when it became clear for the major Polish decision-makers that the very same Western governments could be persuaded to reduce Polish foreign debt only in return for initiating, pursuing and completing such a reform, which would be of exceptional importance to those governments, i.e. rapid transition to a free market system modeled on Western countries.

Introduction

The purpose of my thesis is to examine the role of foreign debt in the economic transformation in Poland in the years 1989-1994. In the literature on the subject, no study to date has analyzed correlations between foreign debt and economic reform in Poland during this period. In doing so, I would like to contribute to a better understanding of the mechanisms that allowed the unique Polish economic reform to be completed at the originally scheduled time, i.e. in 5 years between autumn 1989 and autumn 1994. I try to prove that the reform, understood as the rapid transition to a free-market system modeled on Western coutries, was brought to an end mostly thanks to the Polish authorities' relentless desire to obtain substantial reduction in foreign debt.

This peculiar correlation between radical systemic reform and debt reduction proved long-lived due to an exceptionally strong political dimension of the Polish debt crisis. In 1989, Western governments held over two-thirds of the Polish debt, and this ultimately determined the unique character of the economic reform in Poland after 1989. In the Autumn of 1989, this structure of Poland's debt urged the new government of Tadeusz Mazowiecki to take due account of the expectations of Western governments as to the future shape of the Polish reform. Thus, a specific conditioning was established, which remained in force throughout the whole period of economic transformation. Its essence can be illustrated as a scheme in which Poland obliged itself to carry out the rapid transition to the economic system modelled on Western capitalist countries, while the latter made a unique foreign debt relief conditioned upon the Polish governments' continuous efforts to keep that commitment. The debt relief came, first in 1990, in the form of an unprecedented suspension of debt service to the Paris Club, and later, in 1991 and 1994, in the form of an unprecedented reduction of foreign debt, i.e. debt cancellation of more than 50 percent.

In the literature on the economic transformation of Poland, as well as in the public perception, the economic reform launched on January 1, 1990 has been mainly referred to as 'shock therapy', 'Big Bang' or simply 'the Balcerowicz Plan', after the Minister of Finance who was in charge of the program.[1] Although the need of 'shock therapy' was emphasized by the IMF

[1] [1] Leszek Balcerowicz (1947-), a Polish economist. He was the Minister of Finance in 1989-1991 and 1997-2000 and the president of the National Bank of Poland in 2001-2007. He is best known for implementing the radical economic program in January 1990, whose aim was to build a free-market economy in Poland. Unlike the name of the reform suggests ("the Balcerowicz Plan"), Balcerowicz was in the first place an efficient executive of the reform program, whereas it would be difficult to name all the authors of the reform and to measure their contribution. On the one hand, it was a a typical IMF structural adjustment program adapted to the conditions of the Polish economy, on the other - Balcerowicz's domestic and foreign advisers had a big influence on the

already in the spring of 1989, it was not feasible under the then existing conditions in Poland. It was not until the formation of the government by Tadeusz Mazowiecki in September 1989 that such a reform became viable. Although the term 'shock therapy' is justified from the perspective of the IMF program requirements, the key and most strongly emphasized by the Polish government were both political and geopolitical implications of the reform, i.e. a *quick* transition from a centrally planned to a free market system based *on the Western model*. This is how I understand the Polish economic reform in this thesis.

Only such a perception of the Polish reform in the West corresponded with the Polish governments' desire for the large-scale debt reduction. For the IMF, though, the aspect of the 'big leap' to a market economy was no less important. Thus, the main actors in the international community, on whom the future debt reduction depended, considered two objectives as the main criteria for evaluating progress and success of the Polish reform: a far-reaching change in the economic system and a pace of this change, which – in short - implied the rapid transition reform. It should be emphasized that the two words were inseparable: the pace of the reform refered not only to macroeconomic stabilization, but also to institutional changes, and, vice-versa, the systemic reform was expected to be carried out quickly. Eventually, only the reform of such scale justified a prospect of receiving substantial debt reduction from the West.

Foreign debt as an 'anchor' of the rapid transition

Though adopting in my thesis the different perception of economic reform in Poland, I deliberately use the key term associated with 'shock therapy' (understood as a radical macroeconomic stabilization), namely, an 'anti-inflationary anchor'. In economics, a nominal anchor is an inflation stabilization measure which serves to fix a macroeconomic variable as a way to keep prices at a certain level. The two nominal anchors were included in the Polish stabilization program of 1990: an exchange rate pegged to the dollar at a fixed rate and a tax on excessive wages (*pol*. *popiwek*). In my thesis, I try to demonstrate how a prospect of debt reduction was gradually becoming - to use the 'shock therapy' terminology - the most effective 'anchor' to the reform process. Using this term in reference to debt reduction, I'm aware of departing quite far from its strict economic definition. However, my goal is to show

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program (among the most important were: Marek Dąbrowski, Stanisław Gomułka, Stefan Kawalec, David Lipton, Jacek Rostowski, Jeffrey Sachs). In an interview made by the author, Stanisław Gomułka said that "the reform was mainly developed by the IMF - in, say, 60 percent".

that it was the prospect of debt reduction that eventually pushed successive governments back on the course of the ‘rapid transition’, one condition of which was the inflation stabilization.

The purpose of the thesis is to prove that the Poles’ desire to obtain large debt reduction allowed them to complete the transformation reform in the form of two IMF programs carried out in Poland between 1990 and 1994. However, in the fall of 1989, the prospect of debt reduction was in the area of far-reaching plans or even 'wishful thinking'. Before this prospect became more pragmatic, the government of Tadeusz Mazowiecki had to decide on a variant of economic reform it was supposed to carry out. It should be clearly stated here that Poland in 1989 was a bankrupt with zero credibility in the international arena. This situation was a result of the two decisions that Western governments had made on Poland in 1982: firstly, they imposed economic sanctions on Poland in response to the introduction of martial law, and, secondly, they decided not to declare Poland in default – the decision, that in the following years would force the Polish authorities to negotiate permanently with Western governments to reach a settlement on outstanding foreign debt. Thus, throughout the 1980s, Poland was consistently discriminated against by Western creditors, which manifested itself simultaneously in the credit blockade and the Paris Club’s insistence of being repaid on time.

As a result, in 1989, Poland, on the one hand, had to cope with a deepening economic crisis, and on the other, its room for maneuver in dealing with the crisis was constrained by the huge foreign debt burden. By 1989, Poland’s international status was that of an 'unimportant' country, in the sense that it did not have significant strategic importance to Western countries. More importantly, even the Poland's peaceful democratic revolution did not turn to an effective bargaining advantage in international negotiations. The emerging new democratic elite in Poland, stemming from ‘Solidarity’ movement, was convinced that the democratic changes would establish a sufficient ground for Western governments’ great financial aid for Poland. When those claims were rejected by the West, the very same elite came to a conclusion that Poland's sole international asset could be a strong commitment to the unprecedented transformation reform.

In 1989, the enormous debt to Western official governments, the democratization process and a clearly pro-Western attitude of the new government in Poland made the Paris Club countries - instead of private banks as was the case so far – the main negotiating partner in the debt talks. This proved to be of crucial significance to setting the range of available economic policy options. Ever since, the path to financial credibility (i.e. restoring a confidence in private capital markets) ran through an establishment of ‘reformist’ or, say, ‘european’ credibility. The latter necessitated not only macroeconomic stabilization but also introduction of institutional changes, which was supposed to be done as fast as curbing inflationary pressures. Thus, the speed of a systemic reform and the determination of the reformers became primary criteria for the credibility of the new authorities in Poland. Since 1989, in the eyes of Western financial institutions and governments Poland was credible as long as it implemented the rapid transition reform.

The role of foreign debt was paramount in this regard. Debt reduction was a 'bridge' between 'european' and financial credibility. Without it, Poland would be expected to meet debt payments to the Paris Club in accordance with terms negotiated in rescheduling agreements during the 1980s and, more importantly, would not regain credibility in the long term, even if carrying out strong economic program. In order to increase the chances to obtain debt reduction, the Polish authorities had to 'deserve' it through the completion of the first IMF stand-by program in 1990. Subsequently, a first tranche of debt reduction granted in 1991 enforced the continuation of the rapid transition reform as a prerequisite to receive the second tranche. Debt reduction was expected to hinder the departure from the once chosen path of building a Western-style capitalist system. As Stanisław Gomułka, one of the co-authors of the reform in 1989-1994, said: "The debt reduction was granted to Poland with a view to increase the chances of the success of the transformation reform".[2] Therefeore, it was possible only in concert with the continuing implementation of the rapid transition reform and only as such it guaranteed long-term credibility - both 'european' and financial one. In the meantime, during the period 1990-1994, Poland obtained only ‘conditional’ credibility, and, thereby, obtaining the full debt reduction also became highly uncertain.

The disciplinary role of the International Monetary Fund

In mid-1989, Western governments recognized that without early financial assistance the Polish fragile democratic experiment would collapse, carrying a threat to the stability of the post-communist region undergoing economic transformation. Therefore, these governments considered providing financial support to the communist government in Poland, although on a much smaller scale than the latter expected. I try to show that in the second half of 1989, the key role in coordinating financial assistance to Poland was taken over by the International Monetary Fund, which developed a new model of trilateral cooperation (IMF-Paris Club-

[2] Author’s interview with S. Gomułka.

Poland). The Fund managed to extend the transitional period, in which governments did not provide substantial financial help to Poland, until the establishment of the democratic government, and thus conditions were created for a radical economic reform in Poland. More importantly, even before Mazowiecki was appointed Prime Minister, the IMF had anticipated that such a reform would be possible only if Poland was granted "less orthodox and more generous assistance". It soon turned out that what the IMF experts had in mind was a significant foreign debt reduction.

The role of the IMF was not only limited to persuading Western governments to abandon the plans of providing Poland with financial support, which the Fund referred to as "political money". In 1990, along with the tireless efforts of the Polish negotiators, the IMF strongly engaged in activities aimed at granting Poland foreign debt reduction. Furthermore, over the years, the Fund representatives demonstrated great flexibility when negotiating with the Poles the key issue for the future success of the rapid transition reform, i.e. the size of the budget deficit. Finally, the IMF pushed for successive Polish governments to continue transformation reform and reminded them about ever decreasing chances of obtaining debt reduction otherwise. It should be noted here that the case of Poland-Fund cooperation demonstrates the very different perception of the IMF by a highly-indebted country to that known from Latin America, where the Fund has been harshly criticized. Cooperation with Poland shows another face of the IMF: institution that was flexible and genuinely involved in the success of economic reform.

The key role of the IMF in the Polish transformation is evidenced by the fact that it had developed a general scheme for the cooperation with Poland before the democratic government came to power. This scheme envisaged that if Poland undertook a "strong reform", the IMF would provide financial assurances for Poland from Western creditors, which was a condition for the conclusion of the IMF stand-by agreement. The IMF proposal implied that by choosing a ‘radical’ instead of a ‘phased’ approach to reforming domestic economy, Poland could gradually, and incidentally, extricate itself from the debt crisis, in which it had been stuck for a decade. This proposal was first presented to the last communist government in 1989, but for political (rather than ideological) reasons it could not undertake a radical reform which was forced through by the IMF. By contrast, the new democratic government was able and willing to implement it because it gained support both in the country and abroad. Regarding the economic program itself, it had been largely prepared already, and, eventually, the IMF fostered its adoption in Poland by withholding cooperation with the communist government over the "more gradual approach". Thus, the Fund paved the way for a radical reform in Poland, which the new government subsequently presented abroad as the rapid transition to a free-market system modeled on Western countries.

Correlations between debt reduction and economic transformation

The main purpose of this thesis is to argue that the rapid transition reform was inextricably linked with debt reduction: first, in the period 1989-1991, it was this reform that enabled debt reduction, and afterwards - vice versa. Accordingly, the thesis is divided into two parts. The first part describes how the implementation of the rapid transition reform increased chances for the debt reduction granted in 1991, and the second part argues that it was the willingness of the reformers[3] to finally get the country out of the debt crisis that necessitated the continuation of the rapid transition reform by successive governments.

The first chapter is devoted to describing financial situation in Poland in the period 1981-1982. Its purpose is to indicate the roots of the financial and economic crisis in 1989 and the beginning of treatment of Poland as a special case by Western governments (chapter I). At the end of 1989, Poland committed itself to carry out unique transformation reform primarily to restore credibility abroad, which it had lost in the 1980s (chapter II). Already with the start of macroeconomic stabilization, both the government and the IMF launched an offensive on the international arena to enhance the chances for debt reduction (Chapter III). However, despite a highly satisfactory performance under the IMF program in the first half of 1990, the Paris Club was still reluctant to forgive substantial part of the Polish debt (chapter IV). It was not until the fall of 1990 that vague prospects of debt reduction emerged on the horizon.

The Paris Club Agreement of 1991, which guaranteed an immediate and permanent first tranche of debt reduction, officially stipulated that Poland was obliged to continue the rapid transition reform in the form of a new three-year IMF program if the second tranche was to be granted in 1994, followed by private debt reduction. However, even prior to the Agreement, the strong desire to obtain debt reduction accelerated the Polish government's actions under the first IMF program (chapter V). At the end of 1990, when a period of adjustment fatigue began and further cooperation with the Paris Club was at risk, it was the prospect of the

[3] Hereinafter I will use the term 'reformers' to refer to a group of economists, including successive Ministers of Finance and especially their advisers. Sometimes the latter became the former as was the case with Karol Lutkowski (January-February 1992), Andrzej Olechowski (February 1992- June 1992) and Jerzy Osiatyński (July 1992-April 1993). However, among the most influential advisers were Stanisław Gomułka (during the whole period of the reform), Stefan Kawalec, Jacek Rostowski, Jeffrey Sachs, David Lipton.

imminent debt reduction that became the most effective motivation for the Poles to complete the IMF program signed in February 1990. This correlation worked perfectly in the years that followed. In 1992 and 1994, a similar situation occurred: it was the desire to complete the debt reduction process as scheduled that turned out to be the main driving force behind further cooperation with the IMF and official creditors.

The pursuit of debt reduction enforced adherence to stringent economic policy - the more stringent it was, the bigger the delay in undertaking necessary fiscal meaures under the existing adjustment fatigue. The restrictiveness of the reform was manifested, on the one hand, in external credit restraint, which the Polish authorities deliberately imposed on themselves (chapter V). On the other hand, after 1990, the anti-inflationary policy boiled down to maintaining a tight budget, while the 1991 Paris Club Agreement informally stipulated that Poland was obliged to maintain international reserves at the proper level which would allow authorities to meet payments due after 1994, when a ‘window of opportunity’, i.e. three-years period of lowered (reduced) interest payments, expired. The implications for the economic policy were unique in the region, i.e. the need to quickly restore and maintain both domestic and external balance under the threat of losing full debt reduction.

The key period of the rapid transition reform was that of the ‘window of opportunity’ in 1991-1993, during which Poland became a hostage to a change in its own image abroad made at the end of 1989. The first part of this period was marked by the departure from the transformation reform resulting from a strong domestic pressure to ease the austerity. Poland’s recommitment to the path of the rapid transition was ultimately achieved in an informal agreement between the IMF and Poland, which I call in the thesis ‘the March Consensus' concluded in 1992 (Chapter VI). The consensus confirmed the validity of the Paris Club Agreement, making the triggering of private and official debt reduction dependent on the implementation of the three-year program under the IMF program concluded in 1991 (Chapter VII).

In 1994, further Poland-Fund cooperation was seriously threatened since the most difficult part of the rapid transition reform had already been completed and the Paris Club had granted the second tranche of debt reduction. However, obtaining the private debt reduction was still uncertain. In this situation, the IMF attempted for the last time to exert pressure on the Polish government by linking enhancements for financing of debt reduction to the continuation of stabilization-cum-systemic reform (Chapter VIII). Thus, the Paris Club and the IMF became major guarantors of the continuation of the rapid transition reform in Poland in the period 1989-1994. This is not to say that the Polish reform would not succeed without debt reduction, but that the latter became the sole factor which could persuade the Polish authorities to stay the course of the rapid transition reform when its continuation was gravely endangered.

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In my thesis, I do not focus on the influence of the US administration on the IMF decision-making process – this topic has been thoroughly examined in the recently published IMF studies.[4] It is claimed, however, that the IMF decisions regarding Poland were made from the point of view of their influence on the neighboring countries. In this way I would like to explore the under-researched aspect of IMF programs, i.e., spatial correlation between variant of economic reform in a debtor country and the long-term, region-focused interests of the IMF.

During the Cold War, the world's greatest debtors – Mexico, Brazil, Argentina, and, to a lesser extent, Poland - were the countries of a strategic importance for the USA. In 1989, at the outset of the transition, Poland retained international significance as a pioneer of democratic changes in the region, but the IMF decided to use this asset to maximum advantage and to push through a historically unique economic reform. The key factor here was Poland's huge debt burden, which distinguished the country from others in the region, and, therefore, turned into such an effective tool. The Polish economic reform could be regarded as a typical orthodox IMF program and, as such, it would not deserve exceptional financial support. However, since the reform was perceived in the West as a unique rapid transition to a Western-like capitalism, Poland was granted highly-conditioned debt reduction, which largely determined the success of the reform.

Several books and articles devoted to Poland-Fund cooperation have been published to date, in which the significant role of the foreign debt factor is acknowledged.[5] It is my intention in this thesis to thoroughly examine this role and argue that it was mainly due to the foreign debt issue that the Polish reform can be viewed as one of few successes in the recent history of the IMF.[6]

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[4] Grigore Pop-Eleches, *From Economic Crisis to Reform IMF Programs in Latin America and Eastern Europe*.

[5] Bjork, J., *The Uses of Conditionality: Poland and the IMF*, East European Quarterly,1995; Tiongson E., *Poland and IMF Conditionality Programs: 1990-1995*, East European Quarterly, 1997; Stone R., *Lending Credibility. The International Monetary Fund and the Post-Communist Transition*.
2002.

[6] Brau, E., McDonald, I, *Successes of the International Monetary Fund Untold Stories of Cooperation at Work*. The book lists six case studies: Korea, Poland, Turkey, Tanzania, Brazil and Urugway. It does not take due account of the role of foreign debt in the Polish program.

Chapter I. The Polish debt crisis 1981-1982

1. The emergence of political and economic crises

Below I describe political, economic and financial mechanisms from the period 1980-1981, which forced the communist authorities to declare insolvency in March 1981. From then on, for the next 10 years, Poland was technically in default as it was unable to meet its obligations to both groups of Western creditors - private (banks) and official (governments). In the second part of the chapter I present the reaction of Western governments to the introduction of martial law in Poland in December 1981. The most interesting among the economic sanctions against Poland considered by the West was the one that was ultimately rejected by Western governments, i.e. declaring Poland in default. I focus on the debate on 'whether to declare or not declare Poland in default', which aroused among many influential political figures in the United States, but also which drove a wedge between the Reagan administration and West European governments. Most importantly, I try to prove that the outcome of this debate played a fundamental role in determining the room for maneuver of the new democratic government in Poland in 1989, both in relations with creditors and in economic policy options. I also emphasize how important for the Western policy makers was the 'regional' aspect of Poland's debt problems, and that - like in 1989 - it was the main factor determining their strategy towards Poland.

Just before the outbreak of strikes on the Baltic coast in the summer of 1980 that led to a creation of “Solidarity”, the Polish economy already recorded the drop in total output. In 1979, industrial and agricultural production decreased for the first time since World War II[7]. In 1977-1979, Poland’s foreign debt increased by nearly 10 billion dollars, and debt service ratio increased to 4.1 billion dollars[8]. Government and Communist Party leaders were unable to deal effectively with the crisis. They had no stabilization program other than the continuation of a policy led in the previous years. It was based on administratively restraining Western imports only to essential commodities and also on attempts to reduce the output of producer goods in favor of consumption goods and exportables[9].

Beginning from 1979, the government, for the last time in the history of the communist regime in Poland, undertook efforts to save Poland's financial credibility while trying to avoid

[7] Nuti, M. *The Polish Crisis...*, p. 105.
[8] Kuczyński, *After the Great Leap*, p. 132.
[9] Fallenbuchl Z., *The Economic Crisis...*, p.371.

debt restructuring. To this end, it recognized the need to address external imbalance in a more determined fashion than before. In June 1980, the resolution of the Polish *Sejm* (Parliament) stipulated that the only way to improve the economy was to concentrate tasks on areas crucial for balancing the economy. The priority was given to foreign trade as a source of revenues to repay external obligations. Furthermore, lack of fresh credits from the West drastically limited the Communist Party leadership's room for maneuver domestically. Thus, generating and maintaining trade surplus was believed to be a precondition of an overall economic sustainability.[10]

In order to accurately understand the need for an immediate and radical change in economic policy, it is necessary to look at the context of deteriorating credit standing of Poland at the time. As a matter of fact, striving to prove its creditworthiness, the country was losing it rapidly. Already in 1977, financial markets raised interest rates on credits for Poland compared with those for the other CMEA countries. In December 1979, Poland hardly managed to negotiate financial credit from France on very disadvantageous terms, which already indicated that the country was balancing on the verge of financial breakdown. In April 1980, a meeting held in London, where representatives of 32 commercial banks reluctantly offered the Poles a loan on much worse terms than the latter had expected.[11]

At the April meeting, the bankers also expressed their readiness to initiate talks on the terms of debt rescheduling, even though it definitely was not an offer that the Polish authorities expected to receive. Quite the contrary, the former's aim was to convince the private creditors that Poland was willing and able to pay obligations on time. In general, in order to make sure that a debtor is solvent, a creditor examines recent, current and prospective trends in a debtor country's foreign trade. Those indicators were far from favorable to Poland: from 1976 to 1979, trade deficit, though decreasing, amounted to more than 2 billion dollars annually. Under such circumstances, the authorities took a drastic decision to lower the domestic supply of consumption goods and divert them to exports for Western markets. In this way, effort was made to redress imbalance in foreign trade at the expense of domestic market. Thus, instead of starting negotiations with Western banks on the postponement of debt service, the Polish leadership took steps that, eventually, accelerated economic, political and financial crises in Poland.

[10] *Życie Gospodarcze*, June 29, 1980.
[11] Portes R., *The Polish Crisis*, p. 10.

The government's determination to maintain debt service ability at the expense of domestic market was most bluntly expressed by the Minister of Finance Marian Krzak, who said at that time: "We'll spit blood to pay off the debt".[12] The intention to avoid debt restructuring had already been signalled in 1979, though less drastically, by the then Prime Minister, who justified drastic import reductions by saying that "they were necessary from economic point of view. Thanks to them, we have strengthened the position of our country as a good debtor. It also consolidated our balance-of-payments".[13] Furthermore, in order to avoid official rescheduling, the government resorted to such desperate, and ultimately failed, measures as attempts at arranging secretive bilateral negotiations with respective Western governments, with an aim to persuade them not to put the issue of Poland's insolvency on the international forum[14].

Since the main thrust of the government's economic policy was a sharp decrease in imports, it must have resulted in the lower consumption needs of Polish society. The most immediate effect was an increase in meat prices. From the economic point of view, the government's maneuver was rational, since, generally, retail prices had been kept frozen throughout the preceding decade.[15] It also was a move in line with external adjustment aiming at reduction of imports and increase in exports. Thus, it should be viewed as an attempt to stabilize the economy, and not only to improve debt service capacity.

That attempt failed due to a lack of social acceptance to that kind of policies carried out by the communists. Lack of credits and diverting goods for exports led to a rapidly deteriorating situation on internal market. This gave rise to a 'Solidarity' movement. In response to price increases, strikes, initially centered in the shipyard in Gdansk, soon spread throughout the country. At the end of August 1980, divided and weak leadership of the Communist Party signed 'the August Accords' with Gdansk shipyard workers. The authorities not only rescinded price increase, but also promised to satisfy the trade union demands such as increase in personal incomes and better market supply through limiting exports only to those products in surplus on the domestic market.[16]

Thus, in response to domestic developments, the newly established leadership after August 1980, abandoned the policy of 'spitting blood' embodied in tough macroeconomic

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[12] Jędrychowski S., *Zadłużenie Polski...,* p. 74.
13 *Trybuna Ludu*, January 30, 1979.
[14] Portes R., *The Polish Crisis*, p.10.
[15] In 1971-1979, inflation averaged 4 percent.
[16] *21 demands of MKS*. See:https://en.wikipedia.org/wiki/21_demands_of_MKS.

stabilization measures and, instead, continued to pursue the policy conducted during the period 1976-1980: increased production for domestic consumer and external markets was supposed to be achieved by arbitrary cuts in imports through administrative commands. However, in the newly developed circumstances, this policy not only was unable to provide both internal and external balance, but failed to ensure even one of them. In addition, as a result of the implementation of the August Agreements, labor productivity drastically decreased and the workers' strikes reduced extraction of coal, the main hard-currency earner, and, thereby, exports by half.

The drop in production was accompanied by an increase in wages by 25 percent in 1981, as the government accommodated to the demands of 'Solidarity'. This drastically violated the relationship between work and pay. An inflationary overhang emerged as the product of a combination of several measures: 50 percent excess money creation generated by wage increase, coupled with a 20 percent fall in productivity[17] and official prices remaining at stable levels. The crisis in the internal market was visible for all to see: long queues in front of shops, ration cards for most necessary products, widespread speculation and emergence of black market. As a result, in 1980-1981, national income decreased by 18 percent. This substantially reduced a country's ability to meet foreign debt payments.

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The role of political stability in Poland's creditworthiness in 1980 was as important as that of economic indicators. To restore the confidence of big capital it was necessary to introduce economic stability, but also to show a genuine will and ability to respect formerly concluded credit contracts. The latter depended heavily on political developments in the country. During the 16-month period of legal 'Solidarity', Poland was increasingly losing its credibility in the international markets as the goverment, instead of continuning stabilization operation, ultimaltely adhered to August Agreements, with devastating effects on economy.

Prior to the birth of 'Solidarity', the top economic priority of the communist authorities was to bridge the trade gap in order to please commercial banks. This was the last time in the history of the Polish People's Republic when the shape of the government's economic policy was so directly influenced by the expectations of the Western financial circles. Even though the 'policy of spitting blood' was very short-lived, it left a lasting imprint on the strategy pursued in the years ahead by successive governments under the general Jaruzleski's regime. From

[17] IMF Archives, Poland-Box 57, File 3 (1981), *Lawrence Brainard on Poland Meeting: December 16, 1981;* December 18, 1981.

then on, the authorities will regard the ‘policy of spitting blood’ as anti-model of the correct approach to the problem of debt repayment.

The year 1980 was the last one in which Poland put the interests of Western creditors above the domestic needs of the economy. From 1981, until the final debt reduction in 1994, the question of foreign debt service was subordinated to the need to carry out a fundamental economic reform understood as macroeconomic stabilization and institutional changes. As a result, the Polish authorities, both before and after 1989, resorted basically to their own financial resources in implementing the economic reform. In my work, I try to prove that by 1989, the main factor limiting Poland's ability to take credits was the economic sanctions imposed by the West, and after 1989 the main constraint was the Polish authorities' desire to obtain a substantial foreign debt reduction.

2. Poland announces insolvency

Below, I describe a balance-of-payments mechanism that was an immediate cause leading to the decision on notifying the creditors of the country's insolvency by the Bank Handlowy[18] in March 1981. In the next part of the chapter, I try to show that Western governments continually refused to declare Poland formally in default despite the fact that in the months ahead the Polish Government continued not to honor its non-guaranteed and guaranteed obligations. Instead, they decided to make financial claims against Poland, thus ensuring their long-term influence on the communist authorities' policies. Thanks to this, when the democratic pro-Western government seized power in 1989, foreign debt became their most effective pressure on Poland.

1) Loss of control over credit policy

As was seen above, the last attempt by the communist government to increase export receipts to help close the financing gap not only failed but also created conditions for the rise of 'Solidarity'. The union, then, focused on political demands and successfully blocked the government’s attempts to bring the economy out of the crisis, thereby further exacerbating

[18] Bank Handlowy was responsible for settlements of foreign transactions and government debt.

it[19]. Therefore, in 1980, there was an ever increasing need to find solution to both problems: a negative trade balance and a debt service.

One of the financial causes of the Polish debt crisis was a long-lasting practice of ignoring the state of the balance-of-payments[20], which created an extremely high demand for foreign credits. In 1981, this practice completely spanned out of control. For many years, a particular practice had established of making balance-of-payments projections on the basis of large inflows of trade and financial credits. Those projections included, for example, an item called "unbalanced flows, to be covered by additional credits"[21], which referred to the funds, which must be provided for future deliveries of raw material and capital purchases, regardless of a source of such financing. As a result, the government's actual economic policy was subordinated to the need to meet annual economic plans, and, most of all, to the vested interest of the influential state-enterprises, whose power kept increasing along with the decentralization of central powers.

In short, the so-called ‘payment limits’ in the annual plans turned out to be a fiction[22]. The committees operating on an ‘ad hoc’ basis were being established to decide on what category of imports were most urgent currently. Simultaneously, all the details concerning the issue of foreign debt were a closely guarded secret, at least until August 1980. Still, in the late 1970’s, foreign debt was discussed as a separate issue at the meetings of the Political Bureau of the Central Committee of the Communist Party.[23]

The effects of the mismatch between the targets of the balance-of-payments on the one side, and the economic plan, on the other, were most apparent in the corrections made to the structure of imports for 1981, which (contrary to the plan) were made adapted to the drastically lowered access to foreign borrowing. Since the most needed intermediate imports were unavailable in trade credits, in the first half of 1981 the authorities were forced to continue previously contracted imports of investment goods and consumer goods (feed, grain and agricultural articles), mostly under trade credits, as these did not require payments in advance. The main problem, therefore, was the lack of financial credits, which significantly

[19] *Problemy zewnętrznego zadłużenia Polski*, 1981, [in: AAN (Central Archives of Modern Records Warsaw)], p. 19.

[20] Little regard for costs and financial constraints was a systemic feature of the planned economy (S. Gomulka, *Specific and Systemic Causes of the Polish Crisis 1980-1982, p. 43*).

[21] *Podstawowe założenia programu działania Banku Handlowego...,*[in:AAN]

[22] Author’s interview with Z. Karcz.

[23] P. Bożyk, *Marzenia i Rzeczywistość*, p. 87.

reduced the size of producer imports, held mainly in cash.[24] The result of this situation was a very deep slump in exports and production.

Loss of control over the imports policy led to a chaos in the credit policy. Shortage of financial credits dramatically increased the activity of Bank Handlowy in the short-term deposits markets (often obtained with a 24 hour maturity).[25] This meant, firstly, that taking deposits on these markets was not offset by placing deposits for commercial purposes. Secondly, same-day settlements replaced increasingly difficult to obtain short-, medium- and long-term credits for the balance-of-payments needs. Both practices increased the risk of an immediate bankruptcy of the country and gave a clear signal to the Western financial markets about drastically worsening economic and financial situation of Poland.

In early March 1981, the planners predicted that due to insufficient export revenues and lack of new sources of external credits it would be very difficult to finance both imports and debt service simultaneously. According to their calculations, payments deficit in the second quarter of 1981 would amount to 2.6 billion *dewiza zloty* [i.e. about 400 million dollars]. Their recommendation, therefore, was a more strenuous efforts to increase exports and take action to find sources of external financing[26].

The situation was further hampered by increasing price of money borrowed on international markets as a result of skyrocketing interest rates in 1981. Another factor which aggravated Poland's payments problems was the accumulation of interest due and installments of the short-, and medium term credits contracted in 1978-1980. However, the final blow for the financial system came from the commercial banks' withdrawal of deposits.

2) Credit squeeze

On March 5, 1981, during the presentation of Poland's balance-of-payments given in London by Jan Wołoszyn, the vice president of Bank Handlowy, Western banks were considering Poland's request for a 3.1 billion dollar loan needed to refinance the payments due this year. However, the bankers were alarmed by the fact that the request included immediate 1 million dollar bridging loan.[27] The additonal 2.1 billion dollars were required for the second half of 1981. Moreover, the Polish bankers also admitted that the country was in need of refinancing

[24] *Notatka na temat sytuacji płatniczej kraju...,* [in: AAN].
[25] *Problemy zewnętrznego zadłużenia Polski* , [in:AAN].
[26] *Notatka na temat sytuacji płatniczej kraju...,* [in: AAN].
[27] *New York Times,* March 6, 1981.

government export credits as well, which amounted to 4.4 billion dollars due 1981. Independently, a request to the Paris Club was made for new export credits worth 3.4 billion dollars for essential imports. In total, in March 1981, Poland asked Western governments and banks for a 10.9 billion dollar rescue package to help close the financing gap. It was the last moment in the 1980s, when Poland tried to extricate itself from the financial crisis by gaining funds to close financing gap, without having resorted to the debt rescheduling. After 1980, for the next 10 years, Poland was in a state of technical default towards Western government creditors, and for the next 13 years towards private creditors.

Unfortunately, the Bank Handlowy's presentation of financing needs had a sobering effect on Western commercial banks.[28] Although they had been pulling out deposits from Poland since 1980, it was not until now that they started to withdraw on a large scale. As the Polish debt was made up of as much as 2 billion dollars in short (1-month, 3-month) deposits, Western banks refused to renew them. In the first quarter of 1981, the commercial banks reduced the Polish loans by about 1.1 billion dollars by canceling short-term credit lines.[29] Only in March, as many as 200 Western banks withdrew about 500 million dollars in short-term dollar deposits held at Bank Handlowy.[30] In the following months, banks continued credit squeeze. As for the 3-billion dollar loan request, the banks did not extend it, most probably for fear that they would have to keep financing Poland this way as debt repayments come due in the near future.[31]

Withdrawal of short-term credits brought immediate negative economic results as they were of primary importance for the economy. Bank Handlowy used them to pay for the current payments, i.e. debt interest and imports from the West. Poland's Minister of Finance, Marian Krzak, admitted this saying: "Withdrawal of the balances makes it very difficult to halt the industrial decline because we have no foreign currency for imports".[32] However, the real financing gap was even bigger: it was estimated that Poland would require some 11 billion dollars to cover its projected trade deficit and debt service for 1981 only.[33] Banks' herd behaviour exacerbated the Polish balance-of-payments crisis and largely aggravated the country's economic plight.

[28] *New York Times*, April 10, 1981.
[29] *Polityka*, November 31, 1981.
[30] Ibid.
[31] *Washington Post*, March 7, 1981.
[32] Ibid.
[33] *New York Times*, March 9, 1981.

Polish budget was squeezed to a bare minimum and the government faced the choice between maintaining necessary imports and repayment of debt since it was no longer possible to pursue both objectives at the same time.[34] Further debt service would most likely result in the transitional closure of any imports from the ‘second payments region’, i.e., from non-socialist countries. Therefore, the Ministry of Finance and Bank Handlowy came to a conclusion that there was no other option but to declare insolvency. On March 26, 1981, the Polish authorities notified both official and private creditors of their inability to meet obligations due. In this way, the Poles gave priority to payments for goods and services over interest payments. They saved imports to sustain production for the most vulnerable sectors.[35] In doing so, the Polish authorities rejected the ‘policy of spitting blood'. The government declared insolvency, and the debt service was not given priority not only in 1981, but also for the ensuing 10 years. Below, I undertake the effort to show how close Poland was to be declared in default in 1982 by Western creditors and that, ever since, the fate of the Polish economy was in the hands of Western governments and financial institutions. That was of key importance to the shape of economic reform implemented after 1989.

3) Debt management options

In March, the Polish authorities faced the question of how to behave towards the creditors. Their room to maneuver would not have been so limited had the Polish government not avoided the debt restructuring in 1980. What was, however, ultimately at stake for the Polish government was a maintanace of a limited trade cooperation with the West, because in March 1981 it was the reluctance to reduce imports from the West to a minimum that prevailed over the continuation of the debt service. For this reason, the two radical options were rejected from the outset: a unilateral moratorium and repudiation.[36] In the case of the unilateral suspension of payments for an indefinite period, process of debt restructuring would cease and trade cooperation with the West suspended.

In the case of the repudiation, that is, a unilateral and irreversible refusal to repay debts, the consequences would be much worse. Creditors would take immediate actions against Poland. Any amounts paid on the Poland's bank accounts would be locked, and goods exported by Poland arrested. Credit exchange with the West would be suspended indefinitely. Attempts at

[34] Karcz Z., *Zadłużenie Zagraniczne...,* p.43.
[35] Ibid.
[36] *Polityka*, June 26, 1982.

arresting Polish assets abroad would be taken, including ships, aircraft, bank deposits, maybe even equipment in embassies.[37] Further hard-currency exports would have to be held via third countries, which was unsustainable in the long run. The long-term effects of the suspension or denial of payments would probably mean a return to the traditional centralized system of planning, higher degree of autarky and widening the technology gap with the West.[38] Of course, this was the worst scenario, and the real one would probably not entail so many restrictions at one time.

The unpleasant supreme necessity, which had fallen down on the Polish economy, was a state of dependecy of Western imports, and consequently, dependence on the process of debt restructuring.[39] Polish government was left with two options: applying for a multilateral debt restructuring process (option expected by the creditors) or abandoning this option and forcing the capitalist countries to declare Poland in default (option not wanted by the creditors). The Polish government chose the former option as the lesser of two evils. Polish negotiators made it clear, however, that paying interests would be possible only on a condition of receiving new credits, and that made the debt restructuring process extremely laborious and cumbersome in future. In fact, this led to a creation of the ‘vicious circle’ of the debt talks until 1989.

It is not a secret that rescheduling and new credits only by coming ‘in one package’ can help to bring the country out of the debt crisis. Suffice it to look at the relation between foreign debt barrier and functioning of the economy. The main reason for the 12-percent fall in production in 1981 was the burden of foreign debt.[40] In one of their papers on the economic crisis, major economic experts of 'Solidarity' so wrote about the effects of the lack of credit on the real economy: “we do not have funds to purchase the most basic components and raw materials, which bring stoppages in production and decline of national income. The situation is dramatic. We found ourselves in a vicious circle: if we produce less, we export less, and if we export less, we import less, but if we import less then we produce less - and so the circle closes”.[41] This ‘vicious circle’ implied not only the interdependence of foreign trade, debt service and functioning of the economy, since it also became the most serious economic concern for the Polish government in the 1980s.

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[37] Author’s interview with Z. Karcz.
[38] *Zycie gospodarcze,* January 1, 1983.
[39] Process of debt restructuring offers either refinancing (new credits for debt repayment) or rescheduling (deferment of payments).
[40] *Creditworthiness and Reform...*, p. 13.
[41] *Sprawy gospodarcze w dokumentach pierwszej Solidarności*, p. 383 .

Even interest payments alone put enormous burden on the Polish economy. In 1981, the debt repayment took away almost three-quarters of around 8 billion dollars of hard-currency export proceeds, leaving very little to pay for the intermediate imports from the West needed for current production.[42] In sum, the blessing of the debt rescheduling lay in giving the Polish debtor a ‘breathing space’ in dealing with its economic difficulties. On the other hand, an agreement with the creditors on the debt restructuring was made contingent on Poland’s ability and willingness to introduce economic reforms to improve the effects of economic mismanagement.

However, in the following years, the need for a 'breathing space' turned into a deliberate use of subsequent rescheduing rounds to postpone reforms and final settlement of the foreign debt problem. Thus, in the 1980s, a 'stabilization' in Poland's relations with creditors took the shape of attempts at extending 'breathing space' over the following years. Still in 1989, the communist government urged the Paris Club to embrace payments due 1989 by the agreement concluded in 1987, which suspended repayments for 1986-1988. This is how Poland attempted in the 1980s to muddle through the debt crisis. The side-effect was the continually increasing foreign debt burden, mostly on account of accumulation of interest payments.

As I argue further in my thesis, in 1989, the combination of credits and rescheduling 'in one package' was still considered an obvious solution to the Polish economic crisis. During the great political breakthrough in this year, both the communist government and 'Solidarity' on the one hand, and the private and official creditors, on the other, believed that debt rescheduling, backed by a generous credit offer, was the most desirable option. However, what determined the peculiarity of the unique Polish economic reform carried out in 1989-1994 under the auspicies of the IMF was its implementation under external credit restraint. In this thesis, I argue that both the success of the reform and its implementation without foreign financial support were the results of the Polish authorities' strategic goal to obtain unprecedented reduction of foreign debt vis-à-vis Western governments and banks.

[42] *New York Times*, October 28, 1981.

4) Western sanctions

Martial law[43] was viewed as an optimal solution to the Polish debt problem for all parties of the Polish debt crisis except for 'Solidarity'. Many Western bankers received with relief the news of the formation of the military government in Poland. For the government creditors, martial law did not solve the crisis, but it introduced, for a time at least, political stability. Even more satisfied were the Soviets. Not only because the threat to a communist party monopoly was averted, but also because the Polish foreign debt stopped worrying them as the West was deprived the possibility of directly exerting influence on the evolution of Polish economic policy towards a free-market system[44]. It is beyond doubt that the Soviets preferred the settlement of the Polish problems by the Poles themselves.

In response to the introduction of martial law throughout the country, the United States, and some countries of the EC (European Community), imposed economic sanctions against Poland. Below, are the most important financial restrictions. Firstly, government credits and export guarantees to Poland were limited to those of a humanitarian nature only (food and medical supplies) distributed by impartial agencies.[45] Secondly, the official creditors (Paris Club) terminated talks on rescheduling their 1982 debt maturities and insisted that the Poles service all their obligations due 1981 and 1982. Thirdly, in early 1982, the procedure of joining the IMF was blocked following the intervention of the US government in the Fund. Besides, the United States suspended most-favored-nation status, thereby putting high tariffs on Polish exports. Sanctions also included suspension of landing rights for the Polish airline and of fishing rights in American waters.

The list of possible sanctions against Poland was divided into four groups: limited, medium, strong and severe. The latter were: suspension of CCC (the Commodity Credit Corporation) credits; opposition to IMF membership, pushing for hard requirements for Poland’s debt to force default; and suspending most-favored-nation status[46]. It is worth noting that the most severe sanctions were those related to debt, since these were regarded as the most painful for Poland. Ultimately, sanctions came from all the four groups. Importantly, among 'severe' sanctions only the one of Poland’s default was abandoned. The US authorities set three

[43] Martial law in Poland was introduced on the 13th of December 1981 by general Wojciech Jaruzelski and lifted in July 1983. It’s aim was to prevent the opposition (the ‘Solidarity’ mass movement) from gaining more power in Poland and – according to the then official statements – to forestall the collapse of the economy.
[44] In November 1981, Poland officially applied for the re-admission to the IMF.
[45] *American Banker*, March 9, 1982.
[46] Domber G., *Empowering...*, p.32.

conditions for the removal of sanctions: suspension of martial law, release of the political prisoners and resumption of dialogue between the state, 'Solidarity' and the church.[47]

Sanctions immediately changed the attitude of the Polish authorities to the commercial and government creditors in favor of the former. Western private banks were generally opposed to imposing restrictions on debtors, and, accordingly, their position on Poland was rather consistent and unambiguous. They expressed their concern about the growing pressure within the Reagan Administration to use the financial system as an instrument of American foreign policy[48]. They saw the favorable conditions for receiving payments only under the economic and political stability in Poland. The former largely depended on the latter, because the possible Soviet intervention, and its unpredictable implications for the country's security, could lead to a total collapse of the economy.[49]

Polish authorities had assumed that the bankers eventually would take decisions about credits on the basis of economic criteria, and after 13 December 1981 these calculations proved right. With this in mind, the government took concrete steps towards that group of creditors. From then on, the basic premise of the Bank Handlowy's cooperation with commercial banks was: focusing on paying interest payments, making every effort to have these payments refinanced, and stressing the need for new credits".[50] Negotiations with private banks were supposed to develop in a standard way: refinancing and rescheduling in exchange for interest payments as they fell due.

However, this was not a good time for granting new money to Poland. Bankers kept saying: you received large credits and promised that they would modernize the economy by providing dynamics and huge exports. Instead, you have a catastrophic crisis. What guarantees do we have that further loans will allow you to stand on your feet?[51] Such an attitude might be surprising in light of the fact that it was the credit squeeze that provoked a total liquidity crisis for Poland.[52]

Imposition of sanctions was followed by a redefinition of the Polish stance towards the Paris Club. According to Zbigniew Karcz, the chief Polish debt negotiator, the basic guideline of the Polish government became full reciprocity: "if they did not want to talk to us, we also felt no obligation to respect any agreement or to take unilateral action in favor of the countries

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[47] *Christian Science Monitor*, January 21, 1982.
[48] *New York Times*, March 10, 1982 .
[49] Domber G., *Empowering...*, p.21.
[50] *Podstawowe założenia programu działania Banku Handlowego...,*[in:AAN].
[51] *Polityka*, June 19, 1982.
[52] *New York Times*, May 21, 1981.

that boycott us".[53] The Polish government decided that if Western governments refused new loans, the interest payments should be as limited as possible. This virtually meant the unilateral moratorium against the Paris Club, but in the eyes of the Polish government, it was forced on other members of the Club by the use of political criteria by the US administration.

2. Poland on the edge of default

In this section of the chapter, I focus on the climax of the Polish debt crisis, that is, an international debate about the possibilities and consequences of declaring Poland in default. In the period 1981-1982, Western private creditors repeatedly faced a direct challenge to put Poland into default. I will try to prove that Western governments, by rejecting the option of putting Poland into default, made Poland's foreign debt the main tool of political pressure in the years ahead. This had a crucial impact on the limited room for maneuver in the economic policy options after 1989.

The chapter also aims to highlight the international importance of the Polish debt crisis. Like Mexico in 1982, Poland was recognized in 1981 by the international financial circles as the year's most sensational debtor.[54] Even in 1982, until the outbreak of the Mexican crisis, Poland was central in debates about international financial agreements and aid procedures.[55] In 1980-1981, it was the first major European debtor to suffer a loss of creditworthiness since the Second World War.[56] Its hard-currency debt was 25 billion dollars, including 15 billion owed to the capitalist governments and 10 billion to Western commercial banks.

More importantly, the international debate about declaring Poland in default, following the introduction of martial law on the December 13 1981, made the external debt of Poland, only for a short time though, one of the major issues on the East-West agenda. The question of 'what should be done about the Polish debt' drove a wedge between the confrontational-minded Reagan's Administration and a more conciliatory approach of the West European governments. If the economic symbol of *detente* in relations between capitalist West and socialist East was credit cooperation, the Polish crisis marked the definitive end of the rapprochement of the 1970's.

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[53] Author’s interview with Z. Karcz.
[54] *New York Times*, May 21, 1981.
[55] Domber. , *Empowering...*, p. 86.
[56] D. Lomax, *The Developing Country Debt Crisis*, p. 127.

I try to show that in the period 1981-1982, Poland's foreign debt became the main tool for exerting political pressure on the country by Western governments, but also that it became a source of divisions among these governments regarding the proper - soft or hard - strategy towards Poland. I also would like to show that the Western strategy towards Poland was driven mostly by 'regional' considerations. I want to emhasize that it was those three factors that in 1989 played a key role in the emergence of the Western strategy towards Poland. Therefore, my goal in this chapter is to shed more light on the origin of the unique economic reform that was pursued by successive governments after 1989, in the form of a rapid transition to a free-market system.

The period of 1981-1982 was the highest point of the Polish debt crisis. Neither before, nor later, Poland's foreign debt caused so much confusion in the West. On the other hand, the policy which the creditors then adopted towards Poland largely affected the Polish government's perception of the debt problem for the entire decade. Below, I try to explain how it happened.

1) Private banks reject the 'default option'

After the declaration of insolvency of Bank Handlowy in March 1981, the governments of the US and West Germany asked their largest private banks to maintain refinancing of the Polish debt, instead of calling the country in deafult.[57] In the expectation for the general debt rescheduling, the immediate danger of default was staved off[58] even though Polish government's payments to several Western banks had already been overdue.

First private debt restructuring was reached in principle in April 1981, but it was not signed due to disagreements on details. Talks dragged on for weeks and months without bringing the solution. In September, the two parties finally agreed on the conditions: 2.4 billion dollars owed in 1981 to 460 commercial banks were deferred. 95 percent of that amount was to be repaid after four years of grace in seven semiannual payments (during 1986-1989). The interest rate for the rescheduled debt was 1 3/4 percent above the LIBOR. However, all this was made contingent on one condition: Poland was obliged to repay 500 million dollars in interest due that year before the final signing of an agreement, which was set on December 28.

[57] Cohen B., *International Debt and Linkage Strategies...*, p.708.
[58] *New York Times*, March 31, 1981.

However, since the end of 1981, Poland's hidden bankruptcy ceased to be protected by capitalist governments supporting the 'Polish revolution'. The reason was the abandonment by the communist government of the course of a national reconciliation through the introduction of martial law in mid-December 1981. On the other hand, commercial banks, were less bothered about the moral or political dimension of the military *coup d'etat* in Poland than the governments. However, at the end of 1981 they withdrew from signing the rescheduling agreement with Poland due to unpaid overdue interest on liabilities due in 1981 as planned in April.

The Polish problem was discussed at the meeting in November 1981 with the French Treasury, representatives of the IMF and several French private banks. Namely, the problem of the interest payments falling due in December 1981. All participants agreed that delays in interest payments might continue in the form of an informal ad hoc rescheduling without anyone precipitating a formal default.[59] It was exactly one month later that 23 Western banks had received a telex from Poland informing them that the government would not be paying interests falling due in 1981 on their rescheduled debt. They also asked a number of foreign banks for a six-month-bridging credit of 350 million dollars to meet the due interests. This was followed by another meeting in New York at which unanimous decision was made among banks to refuse to grant any loan to Poland. This meant that Poland was technically in default in respect of these interest payments. Although Poland officially refused to pay interest, it was not decided to issue a formal declaration of default against the country.[60]

The cause of a very long process of the debt negotiations with Poland was not only non-payment of outstanding interests, but also a lack of agreement between the European and American banks, which in fact was a reflect of differences of opinions between the West European governments and the US administration. American private banks were guided by purely financial criteria and were complaining about the constraints imposed by the central authorities on the West european banks' room for maneuver. Since the conclusion of the preliminary agreement with the Paris Club in April 1981, the private banks had been under disturbing political pressure from their governments to provide Poland with lenient terms of agreement to strengthen the Polish economy.[61] It is worth mentioning that ten years later, in 1991, the pressure of the Paris Club on private banks, following the former's decision of the

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[59] IMF Archives, November 1981 , Poland – Box 57 – File 3 (1981). *Eastern Europe Debt Situation--Meeting at Bank of France» November 18, 1981*. November 27, 1981.
[60] IMF Archives [...], *Eastern Europe*, L.A. Whittome to the Managing Director, November 27, 1981.
[61] *New York Times*, June 19, 1981.

reduction of the Polish debt, will lead to a serious split between Poland's private and official creditors.

Formal declaration of Poland in default could have happened only if some small private banks (which had much more to lose) did not hold the pressure and step out of line requiring Poland to meet payments due. Such a step could make other creditors - in accordace with the so-called ‘cross-default clause’ - to declare their loans in default to protect their own claims, provoking a financial crisis over a small initial amount of money.[62] In fact, it was only a gentleman's agreement that prevented any bank from doing so. In order to prevent this to happen, few days before installing martial law the Polish authorities paid some money to small banks in Europe and the United States to alleviate the immediate danger of default.[63]

When Poland officially announced its insolvency to banks for the second time in a year, simultaneously asking for new loans, this came as a shock to Western banks not only because they expected to be repaid on account of the interest payments due December’81 before the signing of the April agreement planned for the end of December’82. The polish request was also viewed as an ultimate confirmation of the lack of the so-called ‘protective umbrella’[64] over Poland in the form of a financial help from the Soviet Union.[65] In response, Western bankers unanimously turned down the Polish request, and some of them threatened to repudiate the April agreement if the interest payment was not made.[66] The Polish financial request could have sealed the fate of the ongoing negotiations, but the banks were well aware that declaring a formal default would reduce everybody’s chance of being repaid eventually.[67]

Banks wanted to avoid Poland’s bankruptcy, but did not intend to extend any new credits. All they wanted was to protect their assets without increasing risks. As one French banker bluntly commented on the bankers’ attitude: "You've got to be cynical. Everyone knows Poland is in default. But if we say so, we admit that we're bad bankers who made loans we never should have made"[68], and this would mean that part of the blame for the Polish financial crisis they

[62] *New York Times*, December 15, 1981.
[63] *New York Times*, December 14, 1981.
[64] Western bankers strongly believed that the Soviet Union extended an ‘umbrella’ over all Comecon countries and would eventually repay their debts. Even when these countries, like Poland in the 1970s, experienced temporary cash-flow problems, credits were granted to them because of the faith in the existence of the ‘umbrella’. In Western bankers’ view, the Soviet Union served as a ‘lender of last resort’ to guarantee solvency of the Soviet bloc but also to protect its own credit rating.
[65] *Financial Times*, December 21, 1981.
[66] *New York Times*, December 22, 1982.
[67] *Financial Times*, December 21, 1981.
[68] *New York Times*, February 3, 1982.

should take on themselves. Furthermore, Western banks were aware of the poor quality of the Polish assets to arrest in the case of default.

When the overdue interests were finally paid and the agreement with private banks was signed on the 6th of April 1982, it did not dismiss entirely the threat of the Polish default. Banks expected economic stabilization and, as long as it was not there, they could not count on obtaining the regular interests. The situation stabilized in November 1982, when the next agreement was signed deferring payments due in 1982 for another year. It was exactly that anxiety of banks over Poland's payments capacity over more than one year that determined the duration of the Polish debt crisis on the international arena.

After martial law, the worst dream of Western bankers did not come true, that is, the growing economic and political chaos necessitating the Soviet intervention with difficult to predict consequences. In the face of massive sanctions, general Jaruzelski threw all forces on one side – the private debt rescheduling. The reason for such a step was the recognition that private banks focused only on the financial criteria, and they did not take almost any punitive actions against Poland for introducing martial law. Many years later, the Polish chief debt negotiator recalled that during the negotiations with the commercial banks in Vienna in February 1982, the bankers did not mention martial law even once.[69]

2) US government repays Polish debt

Right after the declaration of martial law, the Polish Minister of Finance asked Western governments for 350 million dollars of bridging loan to cover the decline in export earnings and repayment of overdue interest owed to the Paris Club and private banks.[70] The Minister assured Western governments that Poland wanted to maintain normal economic relations with them. Such a bold request, given the circumstances, was of course rejected by the Club. When the rescue did not come from the USSR either[71], the Polish government could not manage servicing the external obligations on its own.

When Poland failed to repay interest due January 1982 under the US grain credits, it was the US government that directly faced the question of whether Poland should be formally declared in default. At the beginning of 1982, some Republican politicians around Ronald Reagan urged him to declare default on the Polish debt owed to the US. In doing so, they

[69] Karcz, *Zadłużenie Zagraniczne*, p. 77.
[70] Domber G., *Empowering...*, p. 54.
[71] *New York Times*, January 28, 1982.

intended to force the Soviets to bail out Poland, which would significantly reduce Soviet military spending. The plan also envisioned that Western governments would take the same action as the US administration and, through punitive measures against Poland, impose credit sanctions on the USSR.

The first thing that the US Administration wanted to do after the imposition of martial law by general Jaruzelski was to recall Poland's debt on government loans rescheduled in April. This would be consistent with the so-called 'Tank Clause' in the April 1981 agreement, which allowed the creditors to revoke the agreement in case of exceptional circumstances such as use of force against 'Solidarity'. In case of implementation of the clause, debt servicing would become payable immediately, and the banks would be forced to declare Poland in default. However, it would be pointless, because by that time Poland could not borrow on foreign markets, and her foreign financial and fixed assets were rapidly depleting. On the other hand, ignoring the 'Tank Clause' would create a permanent pressure on the government in Poland, forcing the country to acquire hard-curency and continue debt rescheduling. A better option therefore was a concerted suspension of the rescheduling agreement planned for the next year.[72] Thus, the risk of default was averted - this time by the Paris Club.

Only for a short time though. Since as a reaction to Western sanctions Poland refused to respect the financial obligations due in 1981-1982, in January 1982, the Reagan administration decided to pay the US banks 71 million dollars to cover the Polish interest payments due that month under the CCC guaranteed food-buying loans.[73] In return, American banks agreed not to call for Poland to repay its loans in full, which they normally should do prior to receiving reimbursement from the US Government. In 1982-1983, other Polish overdue interests were repaid in this way.

3) Reagan's decision on Poland under attack

Instead of declaring Poland in default, the US Administration recommended Agricultural Department to adopt an emergency regulation that allowed the government to make payments to American banks.[74] Subsequently, the Department amended the existing law requiring notice of default prior to paying Poland's debt by the government. What upset many congressmen was not the government's decision to reimburse banks (after all, it was a normal

[72] *Financial Times*, April 7, 1982.
[73] *New York Times*, February 1, 1982.
[74] Ibid.

practice), but making those payments without public notification.[75] Among numerous opponents to such a manuever was Daniel Moynihan, a member of the Democratic Party, who called the president to explain publicly when the Polish loans should be paid off by the US government without declaring Poland in default.[76] This new practice was also hard to accept for the American taxpayers given the domestic stringent fiscal policy in process.[77] Such a quiet circumvention of legal requirements by the US Administration to avoid activating the 'cross-default clause' had no precedent so far.[78]

Moynihan was not isolated in his protest. Actually, what followed was an intense debate on how to proceed with the Poland's foreign debt, in which the most prominent representatives of the US finances and political life participated. The joint action by the Departments of State, Treasury and Agriculture supported Reagan in his decision on Poland, while the Department of Defense took a tough line against Polish military regime. Furthermore, 40 percent of the House of Representatives opposed Reagan's decision saying that it was not in accordance with the US Banking Act.[79] Against his decision were also trade unions and leading American newspapers, notably the Wall Street Journal. Therefore, when deciding to pay back the Polish liabailities by the government, the president clashed with the most influential circles in the country.

The official justification of the decision from the US Administration was the same as the Paris Club's a month earlier: there was a risk that otherwise Warsaw might be relieved from making good on its loans in the future. As the spokesman for the State Department said: "We intend to make every effort to collect on the debt and the procedure adopted is the best way to do this. Default does not help us to collect this debt."[80] Marc Leland, Assistant Treasury Secretary, made a similar statement: „To maintain maximum leverage, they [the Polish authorities] should be held to a normal commercial concept that they owe us this money, so they should come up with it".[81] Henry Kissinger, the former Secretary of State, put it simply: "Poland's colossal debt to Western banks is the best leverage we have".[82]

The echoes of the 'Polish debate' resounded on Wall Street. Citibank chairman and one of the most powerful bankers at the time, Walter Wriston, when asked whether the West should use

[75] *New York Times,* February 6, 1982.
[76] *Polish economy : hearing...*, January 27, 1982.
[77] *New York Times*, February 5, 1982.
[78] Cohen B., *International Debt..*, p. 710.
[79] *Tygodnik Mazowsze,* 5/1982.
[80] *Washington Post,* February 2, 1982 .
[81] *Polish economy : hearing...*, January 27,1982.
[82] *New York Times,* February 3, 1982.

the Polish debt as a weapon to influence events in Poland, replied: "In my view, if someone were to call a default on that debt you will then illustrate very clearly to the Poles that they had only one friend which was Russia - it doesn't seem to me to be too productive”.[83]

A very different opinion was expressed by Felix Rohatyn, a prominent New York investment banker. He considered the financial capital as the most powerful weapon at the disposal of the US and maintained that "Poland should be put into default as part of a coordinated Western plan [...] The debt held by commercial banks would be acquired by their central banks at a 50% discount. All new credits to Eastern Europe would be halted until the Soviet Union agreed to participate in negotiations on an economic recovery plan that might be linked to arms control talks”.[84] According to Rohatyn, the Soviets should take over the Polish debt in the name of responsibility for Poland being dependent on them politically, militarily and economically. Then they too would probably go bankrupt.

In line with the above argumentation, the Wall Street Journal accused the Reagan Administration of collaborating with the military regime in Poland.[85] Soon, the New York Times joined the WSJ claiming, in a milder way, that the Administration seemed at times to be at war with its own self-image of toughness in foreign affairs.[86] In a similar tone, the decision was criticized by the US labor union leader Lane Kirkland, who argued that by not declaring Poland in default „President Reagan told the Soviets to disregard his tough talk. He announced that the US would not use its most potent economic weapon at our disposal in defense of ‘Solidarity’”[87]. Perhaps the latter was the most important among critical voices towards Reagan’s decision, because it came from the pro-Solidarity headquarters of the US trade unions and seriously questioned Reagan’s deep commitment to the people of Poland.

As seen, in the period 1981-1982, both private and official creditors had a right to declare Poland in default for three reasons: the delay in repaying interest, breach of the ‘Clause Tank’ and repayment of Polish debt by the US Administration. Why did not they do it? According to the official explanation, the default would let the debtor "off the hook", and that was not in the interest of the United States.[88] As I try to demonstrate later in my work, this argument, turned to a very effective instrument of pressure against Poland in the period ahead, especially after 1989.

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[83] *U.S. economic war against Poland*.
[84] *American Banker,* April 17, 1984.
[85] *Wall Street Journal,* December 23, 1981 .
[86] *New York Times,* February 3, 1982.
[87] Domber G., *Empowering...*, p.57.
[88] *Polish economy : hearing...*, January 27, 1982.

The result of the credit blockade against Poland, but without declaring her in default, was that the Polish government, being forced to pay interest, had a negative net payments transfer with the West.[89] As long as this situation persisted, the end of the debt crisis in Poland depended on the attitude of Western governments. This leverage would have been diluted if Poland had not been required to pay back debts as a result of writing-off her debts. Therefore, the decision of not declaring Poland in default was very pragmatic. But symbolically, it was a failure and it also raised some moral doubts. The official line of the US administration behind the decision was to hold Poland in the financial grip by enforcing the country to pay interest.

However, as William Safire emphasized in the New York Times, the essence of the US policy toward Poland was not to strive to recover money, but to end martial law.[90] That was precisely the purpose of terminating the talks with the Paris Club. In light of this, declaring Poland in default – which was the ultimate, most punitive sanction – was supposed to lead to a total trade and credit blockade, by which the United States would strengthen the bargaining power of 'Solidarity' and Catholic Church against the communists. The very fact that the Reagan administration paid back Polish loans undermined its credibility in the eyes of American taxpayers, the Poles and the USSR. The official rationale for this decision was widely received, to say the least, as lack of consistency in the US involvement in the Polish struggle for freedom. Below, I try to argue that the most important factor behind the US administration's decision on Poland was neither concern for 'Solidarity' or to get money back, but the need to maintain cohesion within NATO.

4) Polish debt undermines the Western alliance

The US pressure on the European governments to endorse sanctions against Poland adversely affected relations within NATO.[91] And yet declaring a country in default, to be effective, needed to be supported by the majority of the international financial community. However, West European governments were more than reluctant to declare default on Polish loans for it could bring too many risks and uncertainties for their national banking systems. It must be stressed that Western Europe was much more economically tied with and financially exposed to Poland than the United States. The US banks' exposure in Poland was negligible, but it cannot be said about small West European countries.

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[89] Cohen B.. *International Debt...* ,p. 711.
[90] *New York Times*, February 5, 1982.
[91] Domber G., *Empowering...*, p. 80.

For example, the Austrian outstanding claims on Poland amounted to some 25-30 billion dollars. If, in the case of default, the Austrian government covered, on the basis of export insurance, the costs which were not repaid by Poland on time, its budget would get into serious financial difficulties. Export guarantees had been provided through Kontrollbank, the country's main export credit agency, and the government bore the financial burden.[92] To take another example, West German banks owned about 5.5 billion dollars, i.e. 17 percent of the overall (official and commercial) Polish hard-currency debt. US Government held about 2 billion dollars and American banks - 1.2 billion dollars, which altogether amounted to 13 percent of the total Polish hard-currency debt. Apart from billions of dollars in outstanding loans, West Germany also had an important trading relationship with Poland[93], whereas America's trade with Poland was only a tenth of the EC.[94]

West European concerns about exposure to Poland were not only of a verbal nature. Germany took concrete steps to protect themselves in case Poland goes bankrupt. In December 1981, the Deutsche Bank's chairman established a contingency fund to cover bad debts to Poland.[95] Other three heavily exposed West German banks were Bank fur Gemeinwirtschaft, Dresdner and Commerzbank, all with some 400 million dollars to collect from Poland. They asked the West German central bank to stand by if they got into troubles following the Polish default.[96]

Concerns about possible repercussions from the Poland's default to the economic and financial safety of the West-european banking system were expressed by John Heimann**,** the high officer in the Treasury Department. He warned about the danger of the European retaliation against the US government in case of the Polish default: given the much larger exposure of the US in Latin America than Western Europe's, „it would be distinctly awkward if a small German savings bank were to declare Brazil in default and thus put the country into default to all its international creditors".[97] And that was precisely what the US administration planned to do about the Polish debt, thereby exposing the West European banking system to higher risks.

The US administration was in permanent contact with West European leaders and bankers before making decision on Poland and was well aware of the West Europeans strong

[92] IMF Archives [...], *Discussions with Mr. Stanzel (Ministry of Finance) and Mr. Loeschner (Kontrollbank) on the morning of November 6, 1981, in Vienna on Eastern European matters.* November 9, 1981.
[93] *New York Times*, January 17, 1982.
[94] *The Economist,* October 23, 1982.
[95] *New York Times*, December 15, 1981.
[96] Ibid.
[97] *New York Times*, March 10, 1982.

opposition to the declaration of default, since they feared that it would lead to a chain of default declarations against Poland in Europe, with grave consequences for the whole region.[98] The European allies were also afraid of loosing the Communist trade. At the same time, in their view, Poland would benefit from formally going bankrupt by not having to respect its obligations. Therefore, such a move would be self-defeating.

This situation forced trilateral cooperation among commercial banks, West European governments and the US administration with a common goal of avoiding the Polish default. All the parties made a compromise and thereby preserved the financial stability of the banking system and consensus within the Western alliance. Ultimatelly, the Americans recognized the severity of the situation and the pressure exerted by the West governments made them refrain from declaring a default.

The circumstances, under which that decision was made, demonstrate resemblance between the Polish and the forthcoming Latin American debt crises. When, in August 1982, Mexico declared a moratorium on its debt owed mostly to the US, the American authorities heavily pressed its West European allies for a quick settlement of a rescue loan. In other words, they found themselves in a similar situation as Western banks following the emergence of the Polish debt crisis. West European governments made their consent contingent on obtaining the US guarantee that Western banks would no longer be exposed to danger by announcing Poland bankrupt. The United States could do nothing but agree.[99]

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Below I describe possible repercussions of officially declared Poland's default for the international financial system. I try to prove that Western governments preferred to keep things safe and, therefore, they rejected the option of declaring Poland in default. It should be emphasized that the debate on the Polish debt took place at the height of the East European debt crisis. Importantly, Western governments' fear of 'contaigon effect of the Polish disease' was the greatest asset of the Polish government at the time. I would also like to emphasize that in 1989 Poland's negotiating power was much weaker than seven years earlier. Due to the country’s inability to repay growing debt to Western governments, the latter gained an extremely effective leverage over Poland.

[98] *New York Times*, March 31, 1981.
[99] Crawford B., *US Power...*, p.303.

Below I try to prove that in the period 1981-1982, Poland's bargaining power was based on two factors: the uncertainty of the West regarding the implications of Polish default on the Western banking system and the lack of access to precise data on Poland's debt situation. In 1989, both factors were no longer valid, and that put the new democratic government in a situation with virtually no advantage in relations with Western governments.

3. Possible regional implications of the Polish default

In 1981, the overall Polish bargaining position was weak confronted with that of private creditors. Generally, it can be assumed that debtor's position in negotiations is determined by three variables: its coalitional (domestic) strength, its debt-related resources and its overall (geopolitical, military, economic) power.[100] A challenge posed by 'Solidarity' and a threat of Soviet intervention demonstrated domestic instability in Poland. Foreign debt indicators were very alarming: debt amounting to 25 billion dollars, hard-currency reserves of 300 mln dollars and drastically restraint access to Western credit markets. Finally and more importantly, Poland possesed no investments or assets, which it could use as a leverage over its creditors and this also accounted for the country's weak economic power. The last two variables defined the nature of the Polish debt crisis against the background of regional debt problems. Since Poland neither had liquid assets, nor ability to attract foreign capital or quickly mobilize domestic economic potential to achieve sustainable trade surplus, its debt problem was not only that of lack of liquidity, but pure insolvency.

On the other hand, every debtor also has some leverage over its creditors.[101] Poland was no exception. Its bargaining strength was typical of any huge sovereign debtor. Default would force Western governments to make good on their commitments to honor government-guaranteed credits, and that would pose a burden on their national budgets. Private banks, in turn, would be forced to massive write offs of nonguaranteed loans in case these are not paid. That could lead to a spill over effect first in a banking system of a creditor country, and then, possibly, in the neighbouring countries too. This would pose a substantial threat to the European financial system. For those reasons, neither governments nor banks were willing to put Poland in default.

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[100] Aggarval V., *Preferences, Constraints...*, p.12.
[101] This was briefly expressed by John M. Keynes, who said: "If you owe your bank a hundred pounds, you have a problem. But if you owe a million, it has." [quoted after *The Economist*, February 13, 1982].

It is worth considering how serious the consequences of Poland's insolvency could be. Was the stability of the international financial system in a real danger? According to professor Richard Portes, Poland’s debts were too negligible to pose a threat to the cohesion of the European banking system.[102] At that time, however, many grave scenarios were taken seriously into account. For example, *the American Banker* newspaper predicted that if the US government declared Poland in default, bankers all around the world might become extremely cautious to lend to any country that might not stay within good graces of the Washington. In such case, the number of ‘eligible’ sovereign borrowers would shrink and this would make international lending more risky, as diversification of risk is an essential aspect of all banking. But then contraction of international lending could undermine political stability of many countries, including those friendly or neutral to the US.[103]

This highly pessimistic vision of what might happened merely because of the one small country seems fairly far-fetched. However, much of that anxiety stemmed from the fact that Poland was the first country in Europe after the Second World War, which had fallen into a very serious balance-of-payments crisis. Paradoxically, this situation of Poland was its strongest asset in negotiations with western creditors at that time. It seems, however, that international negative repercussions of the Polish default could probably be brought under control quite quickly. The Polish debt was so widely spread among numerous banks that it did not seem to represent any substantial threat. For comparison, the enormous Latin American debt posed much larger threat to the international banking system for at least three reasons: it was owed almost entirely by the US banks[104]; most ‘latin’ loans were unguaranteed[105]; the overexposure of the US banks in relation to their capital base.[106]

Besides, from the start, many voices were raised which undermined the viability of scenarios predicting financial calamity ahead. At the 36th annual meeting of the World Bank and International Monetary Fund, the point was made that even though the shock stemming from Poland's debt problems might hit West German banking system, it could be handled without threatening a collapse of the international banking and trading system.[107] Probably, banks in the United States, West Germany and some other countries, would be forced to write off their

[102] Author’s interview with R. Portes.
[103] *American Banker*, March 10, 1982.
[104] US banks had definietely larger stake in Latin America than the West German share in the Polish debt.
[105] And that increased the risks of a financial crisis.
[106] For comparison, only some small banks in the West had credits to Poland larger than their net worth.
[107] *New York Times*, October 2, 1981.

Polish loans, cutting into the year's earnings. It seems that it was the only real danger posed by Poland, and not a threat to the international financial system.

However, even if Poland by itself did not bring about prospects of a possible financial meltdown in the West, more serious threat came from possible implications of the 'Polish disease' for Eastern Europe. Declaring Poland in default could encourage the whole Eastern Bloc to follow suit and put a general moratorium on debt repayment. This might set off a freeze in lending to Soviet-bloc countries, and perhaps make credits less available to countries in the Third World.[108] This could result in a general freeze of trade with the Eastern bloc countries, since, as export credits would dry up, Western companies selling to Poland would lose orders.[109] West Germany in particular had an important trading relationship with the Eastern bloc.

Lawrence J. Brainard of US Bankers Trust, who took part in the debt negotiations with the Polish authorities and was in permanent contact with the IMF, warned the latter of the repercussions in other Eastern Europe countries, which would inevitably be affected by the Polish default.[110] In his conversation with Patrick de Fontanay, one of the IMF representatives in the region, he said that although Hungary performed much better than Poland, many banks were not prepared to treat the countries of the Eastern bloc differently.[111] This view was shared by IMF economists, who believed that despite the banks' attitude, the 'market' was forcing them to look at the area as one bloc.[112]

On the other hand, Western bankers were convinced of a fundamental convergence of socialist economies, their trade linkages within the autarkic CMEA, and probably assumed that financial problems of one country immediately translated to similar difficulties all over the block. Many bankers had subscribed to the 'umbrella theory' believing that the Russians would back all hard currency debt to Poland if necessary. When it suddenly turned out that such an 'umbrella' did not exist over the CMEA countries, banks realized that East European governments' resources were limited. Therefore, they started pulling out their money form the region. Thus, the clear risk of a 'domino' situation emerged.

In order to prevent spreading the financial diffuculties of Poland over the region, the Fund's Managing Director, Jacques de Larosière, was trying to persuade banks to come to an

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[108] Ibid.
[109] *New York Times*, August 30, 1981.
[110] IMF Archives [...], *Eastern Europe--Meeting with Mr. L. Brainard of Bankers Trust*, December 17, 1981.
[111] Ibid.
[112] IMF Archives [...], *East Europe*, November 13, 1981.

agreement on Romania, which was most likely to follow in Poland's footsteps. He argued that it would be dangerous if another case of default spread to other countries.[113] In trilateral talks among western Banks, governments and the IMF, it was repeatedly stressed that if the Polish default occurred it was essential that the spread of unease be stopped in Romania.[114] The fear of 'contaigon' was that if the Romanian difficulties increased, banks' attention would turn to other countries in the region. According to Alan Whittome[115], who was the head of the IMF staff mission in Poland, all banks emphasized that due to Poland's difficulties their attitude to lending to Eastern Europe changed sharply in 1981[116], and their reassessment included the USSR too.[117]

Eventually, the danger was averted and 'only' Poland and Romania fell victims to the debt crisis. However, the sequence of events during the credit squeeze in 1981-1982 indicates that the scenario outlined above was very realistic. In 1980, the bankers' rising concern about Poland's solvency led to a slowdown of new credits to the whole region. As a result, medium- and long-term credits dropped to 2.6 billion from 3.5 billion dollars in the year before.[118] Poland accounted for most of the decline. In 1981, Western banks' lending in the region further curtailed to 1.5 billion dollars. Moreover, the Polish rescheduling pushed up the rates of official medium- and long-term credits for all CMEA borrowers from 8/8.5 in July 1980 to 10.5/11, and made these countries dependent on high-cost, short-term borrowing. In fear of running out of liquidity, during the first half of 1981, the East European governments reduced their cash and reserve holdings in Western banks by 1.5 billion dollars. By mid-1982, Western capital markets became virtually closed to Eastern Europe and the debt crisis reached its peak. Banks reduced their short-term exposure in addition to suspending new medium-term credits. There was also a significant decline in loan rollovers.

The crisis was staved off thanks to West Germany's support for GDR and concerted financial support given to Hungary by the international financial institutions (IMF, World Bank and BIS). It is also worth mentioning that private banks themselves came up with the new solutions in case of the regional debt crisis. Following Poland's insolvency in March 1981,

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113 Ibid.
114 IMF Archives [...], *Eastern Europe*, L.A. Whittome to the Managing Director, November 27, 1981.
115 Sir Alan Whittome (1926-2001). In 1964, he joined the IMF as the Director of the European Department. In the 1980s, he was responsible for IMF-accession negotiations and subsequent economic programs in Eastern Europe. Until 1987, when replaced by Massimo Russo on the position of the Director Department, he was the main decision-maker of the Fund in matters related to Poland.
116 IMF Archives[...], *Eastern Europe Debt Situation--Meeting at Bank of France, November 18, 1981*. November 27, 1981.
117 IMF Archives, [...], *Eastern Europe*, L.A. Whittome to the Managing Director, November 27, 1981.
118 *New York Times*, May 25, 1982.

negotiations started immediately to conclude debt rescheduling. As banks were negotiating with a non-IMF member country, they established Advisory Committee (also known as the London Club), the future key institution in a process for restructuring commercial bank debt. This particular experience from the Polish rescheduling strengthened the position of private banks just before the outbreak of the debt crisis in Latin America, and it proved to be very useful. In 1982, commercial banks dealing with the Mexican crisis established an advisory committee on the lines worked out in the Polish case.

Importantly, in 1981, the Polish government had another potential advantage over creditors, which stemmed from the autarkic nature of Poland's economy: in 1981 only the Polish Government knew exactly how much it owed to the West. Western creditors, without complete data on the Polish debts, could not be sure of how the burden of a default would be shared between the public and private sectors or even among the creditor countries.[119] There were no precise estimates of ratios of foreign debt extended by commercial banks in relation to their capital. One has to keep in mind that the foreign debt data provided to Western governments by banking sources were based on information provided to them by the Polish authorities. That is why these data were treated sensitive by the banking sources[120]. Hence, neither banks nor governments could predict the scale of financial problems in the region following Poland's default.

Furthermore, any evaluation of Poland's recovery prospects was viewed as highly tentative, because of the lack of current information on the political and social situation in the country.[121] The Polish authorities, for political reasons, were reluctant to provide any specific details of economic programs that would be implemented. Therefore, discussions with the Polish authorities provided very little evidence of their determination to improve current economic situation.

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As I tried to demonstrate, Western governments, banks and the financial institutions took seriously the threat posed by the Polish debt crisis. They were afraid of the 'domino effect' in the region, which could undermine the stability of the Western European financial system. In contrast, in 1989 the Polish government, while still technically in default, could not use a threat of the collapse of the European banking system or the spread of the crisis over the

[119] J. Boughton, *Silent Revolution. The International Monetary Fund 1979–1989*, p. 321.
[120] IMF Archives [...], *Poland's External Debt*, C. David Finch, December 18, 1981.
[121] IMF Archives, Poland – Box 58 – File 1 (1982). Lawrence J. Brainard, *Prospects for Polish economic recovery*.

neighboring countries. For one thing, by that time the international banking system had taken measures that prepared it for the possible consequences of any heavily indebted country going bankrupt. During the decade of the 1980s, such mechanisms as loan loss reserves or capital buffers had been widely implemented in the Western banking systems. Moreover, by 1989 the financial situation in the region had improved. Romania, the main candidate to follow in Poland's footsteps in 1981, announced in April 1989 that it had paid off almost all her foreign debt. The German Democratic Republic, though heavily indebted, was under the financial umbrella of West Germany. Hungary, despite its huge indebtedness, enjoyed access to western credit markets.

On the other hand, throughout the 1980s, the situation of Poland as a debtor was very peculiar. On the one hand, the foreign debt to Western governments continuously increased, since Poland was still technically in default. As a consequence of the decision made in 1982 by the Western powers of not declaring Poland in default, series of debt restructuring agreements were being concluded with the Paris Club in the years ahead. If, after 1982, Poland had been allowed not to pay its debts, seven years later the new democratic government would have been responsible for that debt, but it would be difficult to determine its current size. Yet the rescheduling agreements of the 1980s precisely determined what amounts and in what years Poland had to repay. In this way, restructuring agreements, as an alternative to a default, helped to maintain the issue of the Polish debt on the agenda throughout the decade. Formerly concluded debt restructuring agreements made it possible in 1989 to officially estimate the Polish debt at about 50 billion dollars, which was 100 percent more than in 1980, when Poland, for the last time, had met all commitments on time.

On the other hand, although in the 1980s the communist authorities did not pay the Paris Club, they permanently sought membership in the IMF. Thus, paradoxically, they were eager to normalize relations with the West. When chances for an agreement with the IMF significantly increased in 1989, Poland had already been a member of the Fund for 3 years. During this period, the authorities provided the Fund on a regular basis with detailed economic data. Their availability was set as one of the conditions for a progress in negotiating stand-by program, i.e a very important objective for the authorities since joining the IMF in June 1986. Thus, in 1989, the condition of Poland’s economy and finance was widely known in the West. The new government could not rely on the 'shock effect' in case of going bankrupt. Besides, from the very beginning, the new democratic and pro-Western government strived to build its credibility in the eyes of the West, thereby, the option of debt repudiation was not even taken into account.

Thus, in 1989, Poland was deprived of a leverage that every large debtor usually has. What the government could do in its financial negotiations with the West was to try to emphasize the need to support the ongoing democratization process in Poland since it inevitably would influence similar processes in the region. However, as I demonstrate later, Western governments and the IMF accepted that argument only partially. Recognizing - like in 1982 - the great importance of the events in Poland for the countries in the region, they viewed political changes in Poland as a unique opportunity to negotiate radical economic reforms. The chances for such a reform increased considerably in the 1980s due to the systematically growing financial dependence of Poland on Western governments and the IMF. This, however, was a result of the decision made in 1982 by Western governments to keep Poland making good on external obligations.

4. Legacy of the debt crisis 1981-1982

While in the 1960s, Poland's payments situation was balanced, the decade of the 1970s was marked by an increasing external disequilibrium. This deficit, however, was in part consistent with intentions of Polish planners, as it was supposed to raise, owing to higher imports, standards of living and, later, bring a steady increase in national income. In the 1980s, in turn, due to the enormous debt problem, the functioning of the Polish socialist economy, with a built-in surplus of demand over supply, struck the barrier of forced trade surpluses. Major impact of the debt crisis on the functioning of the Polish economy lay in that conflict of domestic pressures and western creditors' expectations. Thus, the debt crisis of 1981-1982 changed the paradigm of the development of the Polish economy. The creditors' attitude to the Polish debt problem - with the leading role of the United States – was consolidated following the 'default debate' in early 1982, which only solidified that change in the development paradigm.

In 1982, Ralf Kreuger, the chairman of one of the West German banks, said: “a declaration of default certainly cannot be the answer of a banker (...) In addition to transforming assets into liabilities, a debtor in default will not necessarily feel obliged to repay its debt when better times have come again".[122] In short, default would be used as an excuse by Poland to cease making payments. Without being declared in default, Poland felt obliged to respect her obligations in the following years. The government, therefore, had to struggle to secure necessary financial resources. And that was strictly a field of economic policy, meaning, the way of setting current priorities: 'ad hoc' or long-term, sectoral or systemic, inward or outward-oriented.

Thus, the decision of the US administration not to declare Poland in default directly influenced an area of economic policy choices as it forced the Polish authorities to concentrate on its balance-of-payments problems at the expense of addressing the domestic disequilibrium. An alternative to the default was a continuous process of negotiations on reschedulings, which ultimately created permanent pressure on Poland by Western governments. This process took place on an annual basis since only in this way could the creditors control Polish economy on a regular basis. Furthermore, in the period 1983-1988, despite the declared willingness to cooperate on both sides, Poland did not adopt any IMF-supervised program. All this made the debt negotiations with the Paris and London Clubs so difficult and cumbersome.

Furthermore, while the economic crisis of 1980-1982 brought some lasting elements of every-day life in Poland in the 1980s (shortages, monetary overhang), the debt crisis of 1981-1982 affected permanently the Polish financial system not only through the ensuing debt restructuring process, but it also led to a net capital outflow. As already mentioned, the United States' view was that the most important thing to do about the Polish debt was to try to collect it.[123] As early as 1982, the US influential political figures emphasized that the current direction of net financial flows was toward the West, and it served as a hard proof of a substantial pressure on Poland exerted by the US decision not to declare Poland in default. That is why the US administration considered a declaration of default financially disadvantageous in 1982.[124] It had very important implications for developments after 1989 too, as the authorities - like the communist government in 1983-1988 - had to restore their creditworthiness in the long run and were expected to make every effort to reach a settlement with the creditors. As I try to prove, in 1989 it was the need to maintain good relations with Western governments, as well as the need to reverse outflow of net resurces, that necessitated the new government's commitment to a radical economic reform.

[122] *American Banker*, November 9, 1982.
[123] *The Polish economy : hearing...*, January 27, 1982.
[124] Ibid.

The decision of not decalring Poland in default had crucial long-term implications for the room for manuever of the Polish democratic government in 1989. In 1982, in his report on Poland, Lawrence Brainard pointed out that the fundamental issue was whether there were realistic prospects for economic recovery in Poland. He thought that "if they do not exist, there is little reason to postpone the inevitable default. If recovery prospects do exist - even if subject to uncertainties - then banks should look for ways to enhance the probability that economic stabilization and recovery can succeed."[125] Importantly, Brainard concludes that a feasible economic recovery scenario could be constructed for Poland.[126]

The negative consequences of the Polish default for economic reform in Poland were also emphasized by the Polish adviser to the IMF, Aleksander Zawadzki. In his conversation with Alan Whittome, he claimed that deafult would impede implementation of any meaningful economic reform and that that bridges Western governments had to Poland would be then completely frozen.[127] Thus, Zawadzki accurately identified in the foreign debt a very strong asset of the creditors over Poland in the near future. It served not only as a tool of permanent pressure on political liberalization, but above all, on economic reform, without which the chances of the debt being repaid would be much lower. In 1989, Poland's foreign debt was so high that the new democratic government had to adhere to the expectations of the West as far as the shape and pace of economic reform was concerned.

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The outcomes of the debate on the Polish default consolidated the crucial role of Western creditors in Poland's affairs. They determined the role the debt burden had in the Polish economic policy after 1982, and whether that problem would be present on the Polish agenda at all. If Poland had been declared in default, then - even assuming that the debt would have to be paid some time in future - the recurring problem of finding hard-currency resources would have disappeared for nearly decade. Probably, Poland would have cut financial and trade relations with the West and, having no other choice, completely integrated within the CMEA block - voluntarily or as a result of Soviet intervention.

On the other hand, by not being declared in default, Poland was forced to respect its outstanding debt. First in the 1980s, as the authorities tried to maintain trade-credit relations with Western creditors and prospects of cooperation with the IMF. Then, after 1989, the new

[125] IMF Archives [...], Lawrence J. Brainard, *Prospects for Polish economic recovery*.
[126] Ibid.
[127] IMF Archives, Poland-Box 57-File 4 (1981-1982). *Poland*, A. Nowicki to L.A.Whittome, January 25, 1982.

government strived to achieve some form of a settlement on the enormous foreign debt owed to Western governments, which was a key to restore financial credibility in the long run, and to re-build credibility as a memeber of the European Community. The new Polish elite realized that this could be done only through the continuation of a rapid transition to a free market system on the model of Western countries.

As Poland was not eventually declared in default, the problem of her foreign debt, though frozen in 1983-1988, re-appeared in 1989 and called for a definite solution. It remained only a matter of how and when Poland had to pay back her debts. The quirk of history is that when the foreign debt problem returned in 1989, the new Polish government had very little room for maneuver in economic policy (less then its communist predecessor), but in the following years it was the same foreign debt problem that made successive governments eager to bring about a unique economic reform to an end. The main purpose of my work is to demonstrate how the issue of foreign debt influenced the implementation of the rapid transition reform in 1989-1994.

I PART. RAPID TRANSITION ENABLES DEBT REDUCTION

Chapter II. Road to the rapid transition reform

In the fourth quarter of 1989, Tadeusz Mazowiecki's democratic government made two fundamental decisions that determined the direction of Poland's economic policy for long years to come. These included: to re-establish good relations with Western government creditors, the side effect of which was a compromised relation with Western private banks, and to begin a rapid transition to a free-market economy. This chapter of my thesis is dedicated to how these fundamental decisions were formed. It is my attempt to show that the main driving force in both these processes was the International Monetary Fund, which overhauled West European governments in taking over coordination of financial aid for Poland. Below, I explain why the new democratic government that came to power in September 1989 was limited in implementing free economic policy. On the one hand, this was a consequence of the 'cold war' led for many years by the communist authorities against Western government creditors. On the other hand, it was a consequence of the outcomes of cooperation between the IMF and the last communist government, which resulted in the development of a radical reform program that was not abandoned by the IMF later on.

I start with a description of what did a stalemate in relations with creditors and the Monetary Fund in 1989 consist in. It was at that time that these relations reached the most critical stage. A stalemate from the previous years persisted, which involved the lack of progress in negotiations with creditors that stemmed from the lack of progress in negotiations with the IMF, and *vice versa* – the Fund stipulated that Poland's success in reaching a settlement with the Paris Club creditors was a precondition for cooperation. Below, I also present factors that deepened the stalemate, yet did not occur until 1989. Then, I proceed to describe how the Fund gradually imposed more stringent requirements on the communist government regarding the shape of the economic reform.

Several months later, the adoption of this radical variant of the reform by the new democratic government in Poland together with the shift to cooperation with the Paris Club will become the key factors determining Poland's credibility in the following years. Western governments expected the economic reform to support the ongoing democratization process in Poland, while the IMF was of a thoroughly opposite stance, i.e. that the democratization process created an opportunity for a radical reform. I undertake the effort to show how the IMF, while gradually taking over the initiative in the shaping of the strategy adopted by the West with regard to Poland, made its strategy eventually prevail over the goverments' strategy. Its essential element was the necessity of adopting the radical reform option if Poland wanted to alleviate the debt burden both for the time of the reform and in the long run.

1. Peak of the creditor-debtor stalemate in 1989

The forecast of the IMF in January 1989 saw the possibility of continuing stalemate in Poland's relations with the Paris Club.[128] It should be stressed that this situation, existing since the imposition of martial law, was beneficial to the Poles in short run cash-flow terms. It consisted, on the one hand, in minimising the size of net capital outflows from Poland by continuing the stalemate situation in relations with the Paris Club, the stalemate specified by a failure to pay Western governments. On the other hand, Poland knew it could rely on a revolving credit from private banks. The amount of the said credit was up to 1 billion dollars a year, half of which went for interest rollover. This is what the 'stabilisation' of relations with creditors looked like in the 1980's. However, when in 1989 a horizon of an agreement with the IMF opened up together with a necessity to negotiate some form of parity of treatment with Western banks and governments, the communist government proved powerless.

The stalemate with the Paris Club consisted in that subsequent governments in Poland failed to fulfil four rescheduling agreements they concluded in the 1980s. Poland did not pay interest on the amounts deferred, which were estimated at about 1.5 billion dollars a year in 1986-1989.[129] For instance, in 1989, Poland still did not pay the amounts due in 1989 under the first rescheduling agreement concluded in 1981. As a result, this led to arrears that increased a debt stock. Aside from being in arrears under all four rescheduling agreements, in 1989 the last communist government made no formal request for rescheduling them.

Another controversial issue was a payment of 'moratorium interest' that should took place in 1988. An agreement concluded with the Club in 1987 postponed all payments (interests and

[128] IMF Archives, EURAI, Country Files, Poland, Box 61, *Poland*, Jim Prust to M. Russo, February 2, 1989.
[129] *Zadłużenie zagraniczne Polski i drogi jego przezycię̨żenia [The ways of overcoming the Polish indebtedness]*, *Życie Gospodarcze* [Economic Life], October 5, 1986.

principal) for the years 1986-1988 on the condition that the moratorium interest at the amount of over 500 million dollars be paid in 1988. The aggravated stalemate of 1989 was caused by the fact that Poland made the signing of bilaterals under the 1987 agreement conditional on consolidation of payments under the 1987 agreement (comprising payments due in 1986-1988) in the form of an additional agreement that postponed payments for the years 1988-1989 (including the moratorium interest). Thus, Poland expected multiyear rescheduling, which was opposed by Western governments arguing that Poland, not being a low-income country, would not qualify for such concessional terms.[130] In the creditors' view, this stalemate could only be broken by the Poles agreeing to proceed with the 1987 bilaterals without the quid pro quo described above. Alternatively, from the Polish government's perspective, it could only be broken by preliminary discussions on post-1988 rescheduling, preceeding signature of the 1987 bilaterals. Neither side was willing to meet halfway.

The stalemate in relations with the creditors was additionally aggravated by the stalemate with negotiations with the IMF. In October 1988, at an annual meeting of governors of the IMF and the World Bank, the president of the National Bank of Poland (NBP) Władysław Baka drew attention to "the triangle of international finances" as the key obstacle preventing the success of a "historical endeavor" of a "radical economic reform towards a market system"[131] that, as Baka stated, was being implemented in Poland at the time. The "triangle of international finances" comprising the IMF, the World Bank and the Paris Club, was governed by the rule that "a debtor must come into agreement with all institutions before one of them helps him solve a problem of liabilities". In practice, this came down to a vicious circle of negotiations that could not result in elimination of the credit blockade.

In line with this principle, the necessary condition of the Paris Club for approval of the multiyear rescheduling was that Poland must conclude an arrangement with the Fund. However, according to the position adopted by Poland, the processes with the Paris Club and with the Fund should take place in parallel. Otherwise, starting payments to the Paris Club without a credit from the Fund would be very difficult.[132] Therefore, the government could fulfil the requirement of the IMF to reach an agreement with the Club only if it received a stand-by credit from the Fund at the same time. Otherwise, Poland could not pay interest to

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[130] Ibid.
[131] *Speech by Professor Wladyslaw Baka at the 42. Annual Meeting of Governors of the IMF and the World Bank.* Archives of the Ministry of Finance, Foreign Department: Series no 918; File: Monetary Fund April 14 – October 17, 1988 (66 pages); Item: Attachment no.2 to „The report from the visit in West Berlin by the President of the NBP (National Bank of Poland)".
[132] IMF Archives, EURAI, Country Files, Poland, Box 61, *Poland - Staff Visit*, Minutes of Meeting No. 20, March 22, 1989.

the Club and sign the bilaterals under the 1987 agreement. Hence, the Polish government in negotiations with the Fund repeated the pattern known from the 1980s: "we will pay interest only if you give us new credits." One of the aims of my thesis is to prove that the breaking of the above stalemate consisted in the new democratic government making itself more credible to Western governments and the IMF at the same time by implementing a radical reform without resorting to foreign credits.

2. Western governments open up for the communist government

An opportunity for a compromise between Poland and the Paris Club without the IMF came between April and September/October 1989. Following the Round Table Talks and the June 4 elections[133], Western countries became more conciliatory in their relations with Poland and offered financial aid in recognition of and for the support of the political changes that were taking place. The first sign of the opening of Western governments was the remarks to citizens in Hamtramck made by US President George Bush in April.[134] In line with the Polish doctrine developed by his predecessor Ronald Reagan, which stated that easing of western, post-martial law economic sanctions would come together with political liberalisation in Poland, George Bush accounced that a specific financial aid was to be provided in recognition of the political reforms underway in Poland to encourage reforms yet to come as 'Solidarity' became legal. The reform was to be developed together with the IMF in the form of a program that supported sound, market-oriented economic policies.

This quite broad stance was shared by West European governments. As the Group of Seven (G-7) leaders acknowledged in their communique on July 15 1989, they believed that political progress in Poland cannot endure without economic assistance from the West.[135] In their

[133] The Round Table Talks were the series of negotiations between representatives of 'Solidarity' and communist authorities. They were not meant to remove the communists from power but to share it with the political opposition. The negotiations officially opened in Warsaw on 6 February 1989 and ended in April 1989 with opening the way to the reemergence of 'Solidarity' as the main legal opposition force. One of the consequences of the Round Table were partially democratic elections of June 4, which were a true breakthrough. Their results were as follows: one-third of seats in *Sejm* were open to a free vote and they were all filled with 'Solidarity' people. No representative of the communist authorities gained a vote in this 'free' part, but 65 percent of the seats in the *Sejm* were guaranteed to them in advance. In the Senate, 99 out of the 100 seats left for open competition were also won by Solidarity-backed candidates. These results soon became the main argument for 'Solidarity' indicating the necessity of taking power, as this was the will of Polish society.

[134] George Bush, *Remarks to Citizens in Hamtramck*, Michigan April 17, 1989.

[135] Soros, G. *A plan for Poland*, July 17, 1989. „Polish transformation 1968-1989. Documents and analyses", p.442.

view, the aim of granting financial aid to Poland was to support political changes that were still highly uncertain. Hence, following the declaration of President Bush, both Germany and France decided to take some initiative to help Poland. As one of the IMF experts remarked in internal correspondence, apart from Americans, it was the French who “seemed keen to get things moving”, but also important political figures in Germany were taking an increasing interest in Polish affairs and, as the Fund representative noted with concern, the pressure for an early conclusion of a Fund-supported program could intensify.[136]

One should pay due attention to the fact that the early agreement with the IMF demanded by the G-7 meant a ‘soft’ rather than a ‘strong’ economic program. Firstly, because this very reform was to be consistent with the Round Table agreement on social-economic policy. Secondly because any shock treatment in the economy could endanger the fragile political consensus that emerged during the Round Table Talks. And last, but definitely not least, because the IMF at that stage of the negotiations with the Polish Government (in early summer 1989) estimated the amount of a one-year arrangement with Poland for *less* than 50 percent of the Polish quota.[137] This value of a stand-by credit meant a relatively low support of the IMF for the reform program in Poland which, in its opinion, failed to address challenges the Polish economy was facing at the time.

For comparison, the relatively strong reform program, though still unsatisfactory to the Fund, prepared together by the staff mission and Rakowski’s government (the last communist government) in August 1989 was to be supported by a credit of 50 percent of the quota. In turn, the famous ‘shock therapy’ agreed on in the final months of 1989 was supported with a stand-by credit of 80 percent of the quota. While in 1988, there was no chance to implement the IMF program, in spring 1989 it was already possible. This change of the IMF attitude towards the Polish government should be explained mostly by political reasons and not economic ones. Thus, the Fund found itself pressured by Western governments and until October 1989 did not consider any program negotiated with the Polish government strong and viable.

The pressure exerted by Western governments on the early agreement with Poland concerned the IMF, which feared that the governments would like to break the stalemate with Poland by forcing the Fund to conclude the soft program that was in conflict with its vision of the economic reform. In the Fund’s view, national reconciliation in the form of the Round Table

[136] IMF Archives, EURAI, Country Files, Box 61, *Poland--An Update*, Jim Prust to M. Russo, May 1, 1989.
[137] Ibid.

Talks and sealed by the result of the June 4 elections was important only as a chance of conducting a fundamental economic reform that would bring an economic recovery.

For this reason, Massimo Russo[138], Director of the European Department, who was overseeing ngotiations with Poland, openly criticized the strategy adopted by Western governments to provide 'political' help to Poland. Referring to President Bush's initiative of economic assistance for Poland that would involve "clearing the way" for the provision of 300 million dollars in IMF lending, Russo stressed in his conversation with the chairman of the Paris Club that "if Western governments wish to give financial support to Poland for essentially political purposes, Fund money is not an appropriate vehicle."[139] Hence, the Fund refused to endorse the economic reform understood as a political instrument. What is more, in order to convince the Club to support a radical reform in Poland, Russo made a political argument against the 'soft' program that was a reversed argument of the one used by the governments for granting an immediate aid to Poland. Russo stressed the necessity of decreasing open and repressed inflation in a swift and considerable manner, otherwise the political stabilisation achieved with much effort would become endangered. It was only later that he added that without quickly suppressed inflation a permanent basis for a structural reform could not be established.[140]

Meanwhile, in late June a possibility appeared to conclude the so-called 'interim agreement' between the Club and the Polish government. In his report on the Paris Club meeting, a Fund representative indicated the United States, Germany and France as the key supporters of an early agreement with Poland, and without a Fund program.[141] The interim agreement was to be made before the conclusion of an arrangement with the Fund, yet it would be conditional on such an agreement being concluded in the near future. In practice, this meant that this agreement would cover at least the 1989 payments and Poland would gain extra time for negotiating a better deal with the IMF. The latter was concerned that this would weaken the Polish government's motivation to stop the macroeconomic situation from further

[138] Massimo Russo (1939-), an Italian economist. He joined the IMF in 1964, in 1987 he succeeded Alan Whittome in the position of the Director of the European Department and occupied this post until 1997. In 2011, he recalled this period: „[I was in the IMF] when there was the transformation in Eastern Europe. I was very proud with that. I did the best program of reform in Poland, which became the basis for the other programs." [*Entretien avec Massimo Russo par Ivo Maes entretien téléphonique le 30 juin 2011* ; *Interview with Massimo Russo by Ivo Maes, 30 June 2011*].

[139] IMF Archives, EURAI, Country Files, Box 61, *Poland--Managing Director's Meeting with Mr. Trichet*, May 5, 1989.

[140] Only stable and moderate inflation hinders inflation expectations, and, thus, it makes long-term production schemes, budget planning, privatization and attracting foreign capital, etc. possible.

[141] IMF Archives, EURAI, Country Files, Poland, Box 62, *Visit of Polish Delegation*, Jim Prust to M. Guitian June 28, 1989.

deterioration. The creditors also would benefit in that the interim agreement would include some, if only token, payments to be made by the government. This, however, given Poland's extremally low payment capacity, could unexpectedly impair her position in the eyes of the creditors.

The very same document claims that the United Kingdom was less enthusiastic about the interim agreement: "they felt that a Fund stand-by would be essential and that there would be no advantage in a weak program."[142] The report concludes with a statement of the Fund representative, "we are not (yet) under strong pressure from the Paris Club for early conclusion of an agreement with Poland." Ultimately, it was this lack of consensus among members of the Paris Club that strengthened the role of the Fund in developing the strategy adopted by the West towards Poland. The difference of opinion among Western governments prevented their intentions from being translated into practice, which most probably would convince the Fund to conform to the will of its shareholders. On the other hand, it should be emphasized that even if the IMF was not pressed by the Club at the time, it constantly feared their pressure.

Although in the middle of the year most of the bilateral agreements under the 1987 multilateral rescheduling arrangement had either been signed or agreed in principle, still, no specific undertakings with respect to the payment of the 1988 moratorium interest were made upon initialing of the bilaterals. As I mentioned above, the 1988 moratorium interest were Poland's only liability in 1988, since under the 1987 rescheduling agreement all interests and principal payments due 1986-1988 were postponed. The moratorium interest was to be paid immediately after the signing of the bilaterals with members of the Club under the 1987 agreement.[143] However, Poland was reluctant to take action, as it wanted first to be even only initially ensured by the governments that the payment of the moratorium interest would be postponed to 1989, which the Club did not want to do. Nonetheless, the Paris Club ultimately decided to alleviate pressure regarding that payment and provided Poland with some 'breathing space'.

The effect of this 'revival' in relations with the creditors was depicted by the Polish Minister of Finance Andrzej Wróblewski in Polish *Sejm*, claiming that it took place "after the Round Table, President Bush's statement and his 8-item program. […] The problem is that [the

[142] Ibid.
[143] IMF Archives, EURAI, Country Files, Box 61, *Poland: Relations with Official and Commercial Bank Creditors* (attachment to 'Poland--Managing Director's Meeting with Mr . Trichet'), May 5, 1989.

payment of the moratorium interest] is considered by the Paris Club one of the key conditions for, let us say, further negotiations and standardization, whereas it is significant element that at this moment there is no pressure to pay money under these agreements, and that is very important."[144] However, as he put it himself, it was all just about "this moment". As a result of the Club's concession, these payments were suspended only temporarily and in this sense the stalemate was only frozen for a time, and provided no solution to the issue of Poland's external credibility. This was admitted by Poland's chief debt negotiator Janusz Sawicki in a conversation with the head of the IMF mission. The former expressed his doubts in whether the government obtained funds for paying off the Paris Club by the end of the year.

The problem of the stalemate with the government creditors stemmed from the necessity to fulfil the 'comparable treatment of creditors' requirement before concluding the agreement on a stand-by credit. It was the only way to close a financing gap, i.e. the gap between the government's income and its liabilities to both groups of creditors during the period of the implementation of the stabilization program. Only two options were possible: either to pay both groups of creditors (i.e. banks and governments) more or less the same or not to pay anything to these groups. Below, I try to prove that neither option was possible in the mid-1989.

Due to enormous arrears Poland had little chance to access to new guaranteed credits from the Paris Club that would make the implementation of the 'parity of treatment' principle possible. Moreover, these chances did not grow despite the recent political developments favorable to the West. Janusz Sawicki had a pessimistic view of these chances, indicating Great Britain's and Germany's negligience in this respect. In his view, it was caused by the fact that the case of Poland was too complicated, and the Paris Club creditors did not know how to approach the problem.[145]

Initially, the Paris Club countries came up with an idea of 'new money' contribution from commercial banks to offset a significant part of interest payments to banks. The IMF believed Poland had the opportunity to take up to 200 million dollars from the banks in 1989, which amounted only to one quarter of interest payments. Asked by the Head of the Fund mission in Poland, Jim Prust, "Will this be enough to satisfy the Paris Club?", Sawicki replied it did not solve the problem of the parity of treatment, since the Club will receive less money from Poland compared to money given to the banks in 1989.

[144] *Okrągły Stół: dokumenty i materiały, t. 4*, [*The Round Table: Documents and Materials*] p. 209-215
[145] IMF Archives, EURAI, Country Files, Poland, Box 62, *Poland--Staff Visit*, Meeting No. 13, June 8, 1989.

Sawicki also put forward a proposal for Prust. Emphasising the minimum ‘operational’ reserves at the government’s disposal, which were estimated by the NBP at only 400 million dollars, he noted that if the funds were forthcoming from the IMF, then the possibility would be created for the payment of some interest to the Paris Club creditors. In that case, the latter would agree to the rescheduling of post-1988 payments, since the ultimate issue was how to make payments due in 1989 postponed to allow the implementation of economic program agreed on with the IMF. Prust’s reply left no illusions as to whether an agreement with the IMF was possible without previously ensured ‘parity of treatment’. In his opinion, the Executive Board would reject such a program with Poland, as closing financing gap essentially through rescheduling by the Paris Club while private creditors were being paid was unacceptable.[146]

Lastly, the option not to pay any of the groups was rejected by the communist government, which believed this way it would lose the only source of credits, i.e. Western private banks, which was the case throughout the 1980s. The fact that these credits covered the government’s financial needs only to a negligible extent is unimportant. In a situation where there were no other prospects of foreign funding, the communist government regarded the banks as the sole predictable creditor.

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As can be seen, the greatest obstacle for breaking the stalemate in relations between Poland and its creditors was still the “triangle of international finances”, where the place of the World Bank was taken by Western commercial banks. Rejecting Sawicki’s proposal for the settlement with the Paris Club, Prust acted in line with the above-mentioned fundamental “triangle” principle, which stated that a debtor had to arrive at an agreement with all institutions before one of them could help solve his debt problem. In November 1989, the Paris Club eventually put forward a proposal for suspending the payment completely until the macroeconomic stabilisation operation is implemented. Importantly, some time earlier, the IMF proposed the Polish government it obliged itself to conduct a radical reform and then the Fund would organise financial aid from Western governments. This was a method for breaking the stalemate on conditions dictated by the Fund and Western governments, whereas the banks were pushed aside. In short, the fundamental principle of the “triangle of international finances” was infringed anyway. However, this occured not on the initiative of Sawicki or another representative of the Polish government, but on the initiative of the IMF. It

[146] IMF Archives, EURAI, Country Files, Box 62, *Poland-Staff Visit*, Meeting No. 13, June 8, 1989.

saw the perspective of conducting a radical reform in Poland as more important than strict compliance with the principle of equal treatment of creditors.

Below, I demonstrate that in the same time when the stalemate in relations between Poland and the Paris Club aggravated, the IMF noticeably tightened requirements for the future economic reform and since that time it constantly expected from the Polish government to meet them. Importantly, the stabilisation operation developed by the Fund already in summer 1989 was of the same structure as that actually implemented by the new democratic government from the end of 1989. The elements that changed in the negotiations with the new government were requirements regarding quantification, i.e. performance criteria that determined a scale of adjustment. The performance criteria had to be properly tightened due to a drastically deteriorating economic condition. In turn, the scope of the reform, its sequence and pace the IMF could accept as minimum were outlined already in May 1989. Below, I present the evolution of the IMF stance on the example of changes in the IMF March and May Briefing Papers. Next, I try to explain why the last communist government could not accept a new radical variant of the reform and, lastly, how the IMF developed a compromise solution in the form of a proposal for a "more gradual approach" to the economic reform. I attempt to prove that despite this seemingly compromise attitude, the Fund had no intention to abandon the option of the reform tightened in May. Its stubbornness eventually determined the shape of the reform implemented in Poland from the end of 1989 over the subsequent years. In return, the Polish government was offered by the IMF an exceptionally beneficial debt relief.

3. IMF rejects gradual approach

Already in September 1988, during the Article IV Consultation Mission, the Fund staff singled out the following conditions for concluding a stand-by arrangement (SBA): the need for Poland to reach a settlement with Paris Club creditors of outstanding issues and to establish a track record of successful policy implementation backed by the necessary social consensus.[147] By fulfilling these three requirements, Poland would get a 'green light' to finalize negotiations on a program with the IMF. Below, I attempt to show how these three elements complemented and determined each other in the emerging IMF's strategy toward Poland.

[147] IMF Archives, EURAI, Box 61, *Poland. Briefing Paper - Staff Visit*, March 7, 1989.

The differences between Western governments and the IMF in the strategy of providing aid to Poland are well visible in the case of the track record required by the Fund. Importantly, the determinaton of the Fund's expectations in track record also determined the shape of the future economic reform in Poland. The aim of the track record was to demonstrate a "convincing start" by Polish authorities in implementing a package of domestic policies to reduce open and repressed inflation and to improve the structure of relative prices.[148] However, the thing was not only to allow Poland to develop adequate policies. The essential need was to persuade the Fund and Western creditors that the authorities were *able to carry out* their declared policies. Only then could the track record become the first step towards Poland's restored credibility.

In order to implement the reform program, it was necessary that government actions are socially accepted. In the case of Poland, the need for the track record was determined by an additional factor, i.e. the IMF living memory of the government's failure to conduct a stabilisation operation in February 1988. At that time, the said operation which aimed to suppress inflation and monetary overhang by means of a price increase that exceeded the rate of nominal income growth was impossible to implement due to a protest of labor unions, primarily 'Solidarity'. This protest later turned to two giant waves of strikes that disorganized the functioning of economy in spring and autumn 1988. In the middle of 1989, the track record was intended to show that this time the Polish society would accept the government actions with the imminent outcome of decreasing standard of living, which was to be even greater than the one experienced in 1988.

In the first months of 1989, the Fund mission in Poland did not foresee cooperation with Poland on any form of a 'shock therapy'. Until May, the person who set the tone for the main line of the IMF was the chief of the Fund mission in Poland Jim Prust, who spoke the language of Western governments expecting the relatively soft reform. He drew attention to the need for taking due account in the future track record of the current political context in Poland, namely the ongoing Round Table Talks. He claimed that a social agreement might come into existence soon, to which the Fund itself called the Polish authorities. In such an agreement, both parties, i.e. the government and the opposition, might settle on leaving real wages on the current level. In an internal discussion between IMF departments, Prust noticed that if an overly rigorous track record was imposed now, they would have to tell Poles to reduce wages, although a moment before they agreed on something completely opposite.

[148] IMF Archives, EURAI, Box 61, *Poland. Briefing Paper for Staff Visit*, March 8, 1989.

Therefore, he proposed that a substantial cut in both real incomes and inflation should be demanded but without quantitatively specifying their expected decrease, which was demanded by some of the IMF experts.[149] The substantial convergence of Prust's stance with that of Western governments' is proved by his conclusion that the Fund should not take a position with regard to the Polish reform that was "economically desirable but politically impossible" and risky.[150]

This stance was in contrast to what the IMF mission presented in June, when – as I mentioned above – demanding from Western governments that they did not allow current political events to impose objectives and the direction of the economic reform. Paradoxically, Western governments and the IMF drew completely different conclusions from the political liberalisation that accelerated in spring in Poland. Although they both expected the fundamental economic reform, they had different ideas about it. Governments wanted the reform not to affect the emerging fragile political consensus in any negative way, whereas the Fund saw the progressing democratization as a unique opportunity for implementing radical economic changes.

It should be stressed that from the very beginning, the Fund could not accept the Round Table economic program as the basis for an adjustment program.[151] They could not approve of its incomplete and piecemeal anti-inflation policies. The Fund was also traditionally sceptical towards such solutions as full employment or workers' self-management, which were the guiding principles of the Round Table Agreements. Moreover, although nearly full wage indexation[152] was agreed, until the very end the government and the opposition did not speak the same language in this matter of key importance for suppressing inflation, which was a threat to a credibility of the anti-inflationary action in the future.[153] According to the Fund, the realization of these policies would significantly extend implementation of a free market economy in Poland.

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[149] IMF Archives, EURAI, Box 61, *Poland: ETR's Comments on Draft Briefing Paper*, March 6, 1989.

[150] IMF Archives, EURAI, Box 61. *Poland - Draft Brief*, J. Prust to M. Russo, February 22, 1989.

[151] *Sprawozdanie z konsultacji przeprowadzonych w dniach 05.03 – 24.03.1989 z delegacją MFW, 04.04.1989* [*Report on the talks with the IMF mission in 05.03-24.03.1989*, April 4,1989]; Archives of the Ministry of Finance, Warsaw; Foreign Department. File: Współpraca z MFW, Misja Art. IV, Marzec 1989 [Cooperation with the IMF, Article IV Mission, March 1989; 45 pages].

[152] *Okrągły Stół: dokumenty i materiały,* p. 209-215 [*The Round Table: Documents*...].

[153] Indeed, these differences emerged in full after August 1, 1989, when the government privatized food prices. This triggered a protest of both the Communist Party and 'Solidarity', which demanded full equalisation of wages and prices, while government representatives wanted a 0.8 percent indexation of the rise in wages. They presented this stance at the Round Table Talks.

Eventually, the Fund management rejected Prust's proposals. From then on, subsequent staff teams in Poland strived to make Poland adjust to the "economically desirable" variant of the reform developed by the IMF at the turn of June. As I show further in this chapter, the Fund by persistently attempting to achieve what in those conditions seemed "politically impossible" - as it was in conflict with the will of the governments of Poland and Western countries, and even in conflict with geopolitical conditions - determined the ultimate attainment of its goal.

Apart from the pro-democratic changes, the program was tightened by the Fund for economic and historical reasons. The starting point for radicalisation of expectations regarding the future reform was the drastically deteriorating economic situation with inflation running at about 9 percent monthly and a weakening hard currency balance-of-payments, as compared to 1988. Thus, the need for a drastic tightening of domestic financial and incomes policies was inescapable. Here, the memory of the previous attempts at suppressing inflation was also of major importance. According to the Fund, the current state of economy followed trends initiated by the failed price-wage operation in February 1988. In the first half of 1989, an excessive demand was further fueld by incomes rising considerably faster than prices. As a result, supply did not keep pace with the resultant growth of demand. Shortages intensified, which was followed by a growing pressure on import, which increased external imbalance. The IMF feared that if another reform was unsuccessful, the government would ultimately lose its credibility, which in turn would make it lose the chance for a more fundamental reform.

In the IMF's view, since financial policies so far provided no brake to the inflationary process, the government should make implementing comprehensive and tight financial policies its highest priority. Differences between weak and strong options of the reform can be seen when comparing the IMF mission tasks devised for the sake of the March and May IMF briefing papers.

The May draft brief leaves no doubt as there was no alternative for a radical reform. Back in March, the Fund assumed no particular combination of policies that was "uniquely desirable on theoretical grounds."[154] In line with this, the mission envisaged "some flexibility regarding the adjustment paths for the key variable." This sentence was crossed out from the ultimate version of the briefing paper dated May 31.[155] Jack Boorman, head of the Exchange and Trade Relations Department (ETR), responsible for the substantial tightening of the reform program

[154] IMF Archives, EURAI, Box 61, *Poland. Briefing Paper - Staff Visit*, May 1989.
[155] This sentence was preserved in the previous May versions of the briefing.

justified in a letter to Prust the necessity of making a decisive change in financial policies, which would establish “a credible determination of the authorities' intentions in their fight against inflation.” This policy was directly called “a shock treatment” instead of the gradual approach.[156]

This excessive tendency of the Fund to force shock therapy through in Poland is a good reflection of how immediate objectives of macroeconomic policy changed over two months. According to the March brief, the essential need was “to ensure that real incomes are constrained adequately *ex ante* to allow a progressive elimination of excess demand pressures.”[157] However, Boorman claimed that reducing inflationary pressures mainly through addressing incomes policy was unnecessary. The May version of the draft brief took due account of the proposals made by the ETR and saw it as essential in the first place to substantially tighten financial policies to promote financial discipline, and only then to reduce real incomes, yet – what is characteristic of the difference between the gradual approach and shock approach – the scale of this reduction was to be “significant” and not only “adequate”, as specified in the March draft brief.[158] A tight financial policy should involve, among others, immediate adoption of real positive interest rates, a monetary program consistent with the inflation target, and immediate unification of all exchange rates with the convertible area followed by depreciation of the official rate.

The change of instruments and objectives of economic policy in Poland proposed by Boorman meant not only a stricter financial policy but also a different sequence of anti-inflationary measures. From then on, priority was given to adjusting real interest rates, credit and exchange rate, and only then - as a result of tight financial policies - the anticipated permanent reduction of real incomes should take place. Moreover, the May draft brief also took account of the ETR proposal to demand from the government that specific real income decrease rates be attained, specifically, by 5 percent as a minimum.

Until May 1989, the draft brief envisaged basing the anti-inflationary policy solely on a substantial reduction of nominal incomes.[159] What is more, it took due account of flexibility regarding the adjustment path, and thus it chose not to specify the expected falling incomes. The mission was also expected not to push for several anti-inflationary anchors at one time. It

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[156] IMF Archives [...], *Poland--Comments on the Briefing Paper for Staff Visit*, J. Boorman to M. Russo, May 25, 1989.
[157] IMF Archives [...], *Poland. Briefing Paper - Staff Visit*, March 7, 1989.
[158] Ibid.
[159] IMF Archives, EURAI, Box 61, *Poland--Comments on the Briefing Paper for Staff Visit*, J. Boorman to M. Russo, May 25, 1989.

all together formed the moderate approach to overcoming inflation. In May 1989, the shock treatment became a combination of policies that was “uniquely desirable” by the Fund from then on and which would determine the shape of the future economic reform in Poland.

4. ‘Shock treatment’ in exchange for easing external constraints

Although Boorman saw fast improvement in the balance-of-payments as an element of the shock therapy, the May briefing paper did not take this proposal into consideration. Regarding external adjustment, the mission took the position that the deterioration in the current account balance that had occurred in 1989 should only be reversed. Later, once the current account deterioration is stopped, the pace of adjustment should depend on the availability of financing, and not, as it was until that time, on further demand restraint for balance-of-payment purposes. This left open the possibility of a slower pace of external adjustment (than previously recommended) if new official financing were to become available.[160] Therefore, from then on the priority was to stabilise inflation. As far as external balance was concerned, it was be restored at a slower pace depending on the access to external financing.

Below, I present the first attempt at developing a trilateral cooperation scheme (IMF-Paris Club-Polish government) that was to alleviate the government’s burden of debt payments in return for commitment to a strong domestic reform, while the IMF together with the Paris Club would ensure proper financial assistance. This scheme was also intended to facilitate the implementation of the three preconditions for an agreement with the IMF, i.e. simultaneous attainment of the track record, settlement with the Paris Club and social consensus.

In the above-mentioned conversation with the Chairman of the Paris Club, Jean Claude Trichet, Russo drew attention to the fact that the Fund’s task was not to support democratic processes in member states. However, he did not limit himself to criticising the Western governments’ strategy of aiding Poland. He proposed that money from the Fund together with additional external financing from other sources (through new credits or very generous rescheduling terms) be used to support “major policy adjustments in Poland.” Thus, they could constitute a “credible and mutually reinforcing package.”[161] The package would be

[160] IMF Archives, EURAI, Box 62, *Poland - Briefing Paper for Staff Visit,* May 31, 1989.
[161] IMF Archives, EURAI, Box 61, *Poland--Managing Director's Meeting with Mr . Trichet*. M. Russo to the Managing Director, May 5, 1989.

“credible”, since the internal reform would not be implemented at the expense of aggravated external imbalance and thus external financing and strong economic program would reinforce each other while remaining in line with the principle of balance-of-payments constraint, which was highly important for creditors.

The so devised package would have an additional advantage in the form of increased social support for the reform. Firstly, the Polish authorities would welcome the easing of the external financing constraint, as they were eager to establish credibility with the population. Secondly, additional external financing would translate into higher accessibility of consumer and producer goods, which would increase social tolerance for the reform. Thirdly, demand restraint would not be excessively limited by the curtailment of real wages for balance-of-payments purposes. In short, the objective of Russo’s proposal was to enhance the IMF program acceptability in Poland.

One can say it was an offer aimed at ‘bribing’ Polish society and authorities by means of additional external financing to form conditions that would facilitate implementation of the main objective of the reform, i.e. to restore internal balance. The financing gap in the balance-of-payments will be closed for some time due to the above scheme adopted by Western governments. Thus, the offer entailed a substantial debt relief, yet not in response for political changes (as the EC expected) but a strong economic reform.

The “credible and mutually reinforcing package” proposal was the first evidence that it was Western governments and not banks who were seen by the Fund as its natural partner to cooperate with on the reform in Poland. This cooperation will substantially affect implementation of the reform in subsequent years, above all, in the form of granting a unique debt reduction to Poland. It was the reverse of the traditional model of cooperation between the IMF and member state creditors conducting structural adjustment, in which private banks were a natural partner for the Fund to negotiate with. In the case of Poland, the priority treatment of official creditors was caused by two factors. Firstly, about two-thirds of Poland’s foreign debt was owed to Western governments. Secondly, the role of the latter increased with the democratization process in Poland.

In the above-mentioned speech delivered in June 1989, the Polish Minister of Finance Andrzej Wróblewski informed of a fundamental change in cooperation with the IMF. He confirmed that the primary objective of the future reform program was to overcome inflation as a consequence of adopting the assumption on the priority of attaining internal balance and postponing redressing current-account imbalances.[162] Nonetheless, the Polish government would not accept the other part of the Fund's offer (of easing external constraints), i.e. the shock therapy requirement. As I prove below, the government rejected this variant of the reform due to a social constraint.

During negotiations held in June in Warsaw, the Fund mission expected the government to simultaneously rapidly eliminate budget deficit, implement tight credit control, substantially increase nominal interest rates so as to make them positive in real terms, reduce real incomes through indexation and special tax on excessive wage (*popiwek*) and liberalize prices.[163] It all formed a 'core' package of strict anti-inflationary measures the IMF would not abandon. During the negotiations, the mission itself admitted that this policy package could appear as "excessively austere"[164] as it placed too much emphasis on demand restraint, but still stressed that there was no alternative for tight financial policies[165] and warned the government against using "half measures".

Lastly and most importantly, Prust informed the authorities about preconditions expected from the government to reach a settlement with the creditors saying that the Paris Club "wanted to see a Fund supported program before it would support further reschedulings". He emphasized that as soon as Poland and the Fund could agree on a domestic policy package, which would feature the main ingredients mentioned earlier, one could think of drawing up a complete external financing package designed to close the financing gap, in the form of further rescheduling or new borrowing.[166] Thus, the Fund said that if the government accepted its program, the issue of the stalemate with the creditors was solved. The new conditions stated that from then on, the government was free to negotiate with the IMF the shape of the reform program but could not reach a settlement with the Paris Club any more.

[162] *Okrągły Stół: dokumenty i materiały, t. 4*, p. 209-215. [*The Round Table: Documents*...].
[163] IMF Archives, EURAI, Box 62, *Poland - Back to Office Report on Staff Visit*, June 15, 1989.
[164] IMF Archives, EURAI, Box 62, *Poland - 1989 Staff Visit*, Minutes of Meeting No. 16, June 8, 1989 .
[165] Ibid.
[166] Ibid.

5. Poland's vision of cooperation with the West

During the June negotiations with the IMF on the reform program, the government adopted a social criterion. Instruments, pace and sequence of actions in economic policy were acceptable for the authorities as far as they did not constitute a direct threat for the social peace. In line with this assumption, the Minister of Finance explicitly distanced himself from the shock therapy. He accused the staff mission of being inconsistent, as for a long time they had stressed the need for concluding a social agreement themselves, and now they were forcing through the shock program that was against the spirit of the agreement. He emphasized that he was obliged to follow the Round Table agreements and for that very reason the government program was based on assumptions about what might be politically acceptable.[167]

Wróblewski then singled out main items of the agenda. As for the budget deficit, it would persist for another two or three years. A drastic decrease of the deficit was impossible due to the very strong social constraints.[168] Moreover, there would be no quick adjustment in interest rates to raise them to a real positive level. The government stated that the radical adjustment of the deficit and interest rates would increase inflation. However, there was yet another argument for leaving interest rates on the current level that sounded more convincing in the communists' mouths. Namely, Wróblewski stressed the need for high interest rates to be socially acceptable. He argued that in practice, the entire industry might 'sink' under such a strict financial policy.[169] Moreover, he noted that social considerations prevent the elimination of preferential housing and agricultural credits.

A major area of disagreement concerned real incomes. Due to unclear status of this case in the Round Table agreements, Polish delegates seemed to suggest that real incomes could be held constant or even somewhat increase. In turn, the mission indicated that a fall in real incomes was a necessary condition for the reduction of excess demand pressure but also stressed that, consequently, a continued rise in real consumption would take place. However, Wróblewski defended the agreement with 'Solidarity' and in fear of strikes, he did not want to lower

[167] Ibid.
[168] IMF Archives, EURAI, Box 62, *Poland - 1989 Staff Visit*, Meeting No. 11, June 7, 1989.
[169] IMF Archives, EURAI, Box 62, *Poland - 1989 Staff Visit*, Meeting No. 16, June 8, 1989.

nominal incomes compared to nominal expenses. Interestingly, Poland did not reject elements of the reform that were politically safe, such as exchange rate adjustment.[170]

The Fund was somewhat surprised by Minister Wróblewski's sudden declaration made right after the June negotiations to tighten the reform program in line with the IMF expectations.[171] He thus attempted to accelerate the conclusion of an agreement on the stand-by credit. However, it is doubtful whether this improved the government's credibility. In any case, although the stance adopted by the government evolved towards radicalization of the reform, the radicalism proposed by 'Solidarity' manifested in its financial expectations of the West. A June appeal of the leaders of the opposition in Poland, which was already legal at the time, called *Program pomocy międzynarodowej dla Polski* ("International Assistance Program for Poland"), envisaged that the West would provide 10 billion dollars over a period of three years to ensure stabilization of economy and implementation of a systemic reform. The justification for this enormous scale of assistance was given in the opening of the appeal: "Poland is pioneering the transformation of totalitarian communism into democracy. It is also initiating the transformation of a centrally planned economy into a market economy. The changes in Poland may serve as an example for other countries. If successful, these peaceful reforms, will alter the existing situation within the socialist bloc and will furthermore have a decisive impact on the future shape of East Central Europe."[172]

The Solidarity appeal stemmed from the very same need that was stressed by Western governments, that is, the financial aid for maintaining democratization and stability in the region. Most of the text covers a detailed specification of the purpose of new credits, their sources and timeframes. It is not until the very end of the document that leaders of 'Solidarity' state that the aid to be provided by the West is conditioned on the implementation of an anti-inflationary program by the government. In the view of the West, however, this approach to the sequence of actions was a symbolic reflection of the list of priorities of 'Solidarity'. Hence, some reactions of Western governments aimed at making Poland realize that building credibility on political changes, however groundbreaking, was a wrong path to follow. Credibility was to stem from another source, which was clearly visible in the reaction to the

[170] Government delegates envisaged introduction of 'full internal convertibility', which despite being commented on by the mission as "meaning unclear", could prove that Poland wanted to compensate soft elements with a radical approach in other areas of the reform.

[171] IMF Archives [...], *Poland - Back to Office Report on Staff Visit*, J. Prust to the Managing Director, June 15, 1989.

[172] *International Assistance Program for Poland*, June 22, 1989. Archives of the Ministry of Finance, A/822/22 (Cooperation with the IMF: March 20, 1989 – June 26, 1990).

‘Appeal’ of Alan Walters, who acted as the key economic adviser to Prime Minister Margaret Thatcher.

Walters told the Polish ambassador crudely that Poland’s expectations did not match the international realities. According to a report of the latter, the British politician called postulates made by Solidarity “naive and pathetic”.[173] He compared Poland’s situation to African countries that were in a tragic situation and received no aid. Above all, when criticizing the economic agenda of the Polish government, Walters formulated expectations of the British government towards Poland, claiming that the Polish crisis “regardless of its socio-political conditions, can be solved with radical classical economic methods, proved by the British experiences, such as balanced budget, elimination of subsidies, austerity, active price and exchange rate policies, creating conditions for competitiveness, etc”.[174] Walters concluded his statement by advising the Polish government to base its appeals to the West on economic achievements and not political ones. He said: “Poland has many sympathizers in the West, yet it cannot expect any sentiment”.[175] Thus, the government was made to realize that the path towards credibility led through building a market economy in line with the classic liberal economic doctrine.

It can be assumed that Walters spoke not only for Thatcher’s government, but also for the Anglo-Saxon world and the IMF. The latter believed that the ‘Solidarity’ appeal would not bring Poland any benefits[176], while President Bush called it “absolutely unreal”. The White House Chief of Staff John Sununu went as far as to compare Poles to children by saying that giving Poland new credits would be like leaving kids alone in a candy shop.[177] The underlying message in these comments was that the Western financial assistance would be wasted, as in the 1970s, if not accompanied by radical economic reforms. What the Solidarity’s appeal left behind was the general impression in the West of a low determination of ‘Solidarity’ to repair the economy in a radical manner. It was not without significance, given Solidarity’s status of the leading opposition force most likely to form the next government. However, as soon turned out, the leaders of ‘Solidarity’ drew the right conclusions from the above reaction of

[173] Archives of the Ministry of Foreign Affairs. No. 138, London, July 14, 1989. Ambassador Zbigniew Gertych to the undersecretary of state in the Ministry of Foreign Affairs and the undersecretary of state in the Ministry of Foreign Economic Cooperation on a conversation with the key economic adviser to Prime Minister Thatcher Alan Walters on Poland’s negotiations with the IMF. The conversation took place on July 13, 1989.
[174] Ibid.
[175] Ibid.
[176] IMF Archives, EURAI, Box 62, June - July1989, *Poland-An Update*, J. Prust to M. Russo, June 23, 1989.
[177] *New York Times*, July 11, 1989. He later apologized for the metaphor but repeated that the point he tried to make was correct (*Los Angeles Times*, July 12, 1989).

the West. The democratization itself and openness to cooperation with Western governments could not serve as sufficient grounds for receiving large financial assistance from the West. This required implementation of a reform using “radical classic economic methods”.

In June 1989, however, the Fund still saw no chance for such a reform to take place in Poland. This was not only because Rakowski’s government had low credibility. ‘Solidarity’ was not slightly more eager to implement the strict reform program. After all, it was not the first time that both sides proved their visions of the new economic order in Poland differed from that of the IMF. The agreements made at the Round Table Talks with regard to economic matters were unequivocally defined by the Fund as providing no basis for the future cooperation with it.[178] These differences proved that there still was the stalemate on a reform, yet I show below that the Fund did not intend to wait. It decided on a cooperation based on a new reform program announced somewhat earlier by Wróblewski, which was developed at the end of June. Nonetheless, before the IMF mission came to Warsaw to agree on details of the program, the dynamics of political events in Poland considerably changed the Fund’s strategy towards Poland and the Paris Club in the time period of only two weeks. The main objective of the further part of the chapter is to show that the IMF, seeing how hard it is to push for the radical economic program in the negotiations, offered Poland an extraordinary debt relief as a major incentive.

However, first the Fund drew in August a draft brief in which it provided an outline of a “more gradual approach” to the economic reform in Poland. It was a compromise between the above-described IMF package and the new tightened reform program of the Polish government. Still, it must be emphasized that from the very beginning the IMF mission did not believe there were chances of implementing their new program and it doubted its coherence. Low credibility of both the program and the communist government provided an impulse for a subsequent decision to withhold the “more gradual approach” and propose a new IMF-Paris Club-Polish government trilateral cooperation scheme.

[178] *Sprawozdanie z konsultacji przeprowadzonych w dniach 05.03 – 24.03. 1989 z delegacją MFW,* April 4, 1989...

6. IMF offers a compromise solution

In the Fund's view, the two issues of fundamental meaning for the success of the reform were the social consensus, without which even a comprehensive and strong program would quickly unravel[179], and the proper scale of adjustment (depth, pace, sequence, scope). The "more gradual approach" outlined in the August draft brief contained specific requirements regarding a stabilization plan that will become the unnegotiable minimum program for the Fund. In this context, it can be said that due to a deep scale of adjustment, the "more gradual approach" meant rather a 'less radical approach' or a 'more gradual approach within a radical framework'. Below I present a brief presentation of the core elements of the reform that formed the future Balcerowicz Plan. Next, I focus on factors due to which the Fund did not want to adopt the "more gradual approach" as the basis for its cooperation with Poland.

The 'more gradual approach' emphasized the priority of tight financial policies compared to price liberalization. If in the course of implementation of both these processes it turned out that the pressure to relax financial policies was too high, the Fund would demand that the government adjusted "more extreme [price] distortions" (most probably by reintroducing administrative control on some of the prices) and continued tight financial policies.[180] Other key macroeconomic policy imperatives included: major strengthening of the budget, credit restraint (a zero credit for the government from the central banks and a minimum credit for the economy) and a reduction in real money balances by 10 percent, including a reduction in real wages.[181]

Areas where the Fund allowed for a compromise and which defined the "more gradual approach" involved exchange rate policy, where the Fund agreed to gradual attainment of the unified exchange rate and adjustment of interest rates. In the latter case, although it clearly demande high real or equal-to-inflation interest rates, "in current circumstances" the mission took into consideration that this requirement could be made less strict in the initial phase of the reform. Therefore, the adjustment of the interest rate might be phased, yet in the starting point the rate should be equal to inflation. Characteristically, during negotiations held in November with Leszek Balcerowicz's team, the Fund experts attempted to push for a more

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[179] IMF Archives, EURAI, Box 62, *Poland - Briefing Paper for Staff Visit*, May 31, 1989.
[180] IMF Archives, EURAI, Consultation Files, Poland, Box 82, 1989-1990, *Briefing Paper - Article IV Consultation and Possible Request for Fund Resources* (Confidential), August 1989.
[181] Ibid.

radical approach, claiming that determining the level of a nominal interest rate *ex ante*, i.e. based on past inflation, would mean persistence of high prices, while determining interest rates based on a restrictive inflation target for subsequent months would substantially increase the possibility of reaching that target. The fact that Balcerowicz acceppted this reasoning, which was earlier rejected by Wróblewski's cabinet due to social considerations, provides a good picture of the difference in confidence that the Fund had towards both these governments.

The greatest difference between the programs of Wróblewski and Balcerowicz concerned the matter of the "highest priority in the current circumstances", i.e. inflation. It is worth mentioning that Rakowski's government envisaged a restrictive target of a 2-percent inflation in the fourth quarter of 1990. For the mission, it was an overly ambitious assumption. In its view, the government failed to take due account of outcomes of necessary fiscal changes, exchange rate changes and price liberalization, which together could bring about a very high price surge. In turn, the Fund found the inflation target to be sufficient if it only meant a "clear break from the recent past" while being coherent within the framework of the entire program.[182]

In line with this, the August draft brief emphasized the Fund's willingness to support a sound program of adjustment and reform with reasonable prospects of success.[183] Viability and credibility of the program were the primary objectives for the IMF. It was what the program developed by Rakowski's government lacked, and it was the foundation of the proposal of the "more gradual approach" program. Interestingly, the Fund considered the above-described two elements of the governmental program, i.e. inflation target and exchange rate policy, overabitious and wanted to alleviate the pressure to make the program more viable. The Fund did not believe in the sudden declarations made by Minister Wróblewski regarding the need for radicalization of the program, as from the beginning of the negotiations he made persistent attempts at discouraging the Fund from putting strong macroeconomic policies before liberalization. Moreover, the unreliable assumptions of the reform program gave an impression as if Rakowski's government was striving to reach an agreement at every cost to ensure IMF legitimation in a situation when Solidarity's ambitions and opportunities for participating in power grew with each day. Lastly, a very low social support for the

[182] Ibid.
[183] Ibid.

government and the conflict it had with the Communist Party regarding the proper economic policy additionally undermined prospects for success of the reform program.

However, the greatest weakness lied in the low credibility of the program. On the one hand, the Fund assessed it as ambitious, involving rapid liberalization of the economy and having numerous points within it, with which the staff would agree. On the other hand, there were also "fundamental omissions, ambiguities, and inconsistencies."[184] Furthermore, the program's current status was unknown as there remained many outstanding questions concerning the precise contents of the program and their sequencing, its plausibility and consistency. The uncertainty of the program implementation stemmed from the dynamically changing situation in Poland. In the eyes of the Fund, it all undermined cooperation with the communist government. In these circumstances, the IMF preferred to refrain from sending the August draft brief with the "more gradual approach" to the Executive Board and from going on a mission in Warsaw planned for September. Instead, it chose to adopt a "wait and see" approach.

7. Debt relief as the main bargaining tool

Since the IMF had so many doubts regarding the possibility to implement the 'more gradual program', one could ask why it decided to cooperate with the last communist government in the first place and on the September mission that was to settle the details of this cooperation. Apart from the formal argument to sign the SBA before the Annual Meetings in late September, the Fund felt the additional pressure of time. This was due to the above-mentioned pressure made by Western governments that represented the main group of Poland's creditors, i.e. the Paris Club.

The fact that the trilateral cooperation (IMF-Paris Club-Poland) might form differently than in the direction expected by Western governments is evidenced by a confidential document written by Massimo Russo several days before the August draft brief was devised, foreseeing an agreement with Poland centered on the more gradual approach. Ultimately, the draft was annulled and replaced with a trilateral cooperation concept outlined in the document dated August 11. Arguments for revising this cooperation were provided by the dynamically

[184] IMF Archives, EURAI, Box 62, *Poland*, M. Russo to the Managing Director, August 11, 1989.

changing political situation in Poland. As a result, the role of the IMF increased and that of Western governments was reduced.

In the document of August 11, the Fund tried to be more specific and adjust to new circumstances the June scheme of the "mutually reinforcable and credible package", in line with which Western governments were to ensure the closing of financial gap in the form of a generous debt rescheduling or/and new credits, which would allow the government and the IMF implementation of major policy adjustments. In June, the main obstacle for a radical reform was the social resistance, which was to be softened by the financial aid from the West. The communist authorities well understood the necessity of a substantial economic change, yet were discouraged by the social agreement concluded at the Round Table In August 1989. The Fund still maintained that model of trilateral cooperation but adjusted it to new challenges that emerged in its relations with Western governments on the one hand and Poland on the other.

Russo confirmed the actuality and the need for a mutually reinforcable and credible package in two places in the document. On the one hand, the financial aid of Western governments was to ensure social support for the reform. Russo appreciated the initiative of the European Community to grant aid, food aid and credits to Poland under the PHARE program[185], since "political money can help to ease the social impact and acceptability of reform."[186] On the other hand, Russo saw the significant threat to the trilateral cooperation, outlined in the June scheme, in the plans to grant to Poland concessional terms on debt in the form of the 'interim rescheduling' planned for a period of about 6 months. This agreement would lead to a significant reduction of the Fund's role in the West's strategy concerning Poland, since conclusion of the interim agreement would take place ahead of the conclusion of the IMF program.

The Fund perceived a very strong tendency of Western governments to help Poland, but it wanted to use it in the best possible way. For the Fund, the debt concessions were pointless in themselves "unless they were associated with genuinely firm macro measures and credible reforms."[187] He feared that the interim rescheduling would deprive the government of the motivation to make a strict reform and the additional help in aid or credits would be wasted. Hence, Russo claimed that the Fund had to take over the initiative from the European

[185] Ibid.
[186] Ibid.
[187] Ibid.

Community as regards the strategy towards Poland, and not let itself be treated only as a source of information on Polish economy and, instead, actively participate in the EC effort to help Poland by making attempts to influence governments "by making discreet representations at the political level".

These demarches aimed at combining the Club's debt concessions with the implementation of "genuinely firm macro measures" supervised by the IMF. Hence, as can be seen, the aim was the same as in the June proposal of the "mutually reinforcable package". However, now the June concept of cooperation collapsed since the Paris Club was considering conclusion of the interim rescheduling with Poland. This meant that Polish authorities would not have to negotiate with the IMF, as they received financial aid from the governments. However, assuming optimistically that the communist government[188] efficiently implemented the reform program, it would not succeed at winning the opinion of the West that would be positive enough to gain something more than conventional forms of financial assistance. This would mean that the government, if decided to implement a radical systemic reform, would have a limited room for maneuver both financially and politically, since there would be no social agreement for the reform.

However, Russo foresaw that the perspective of social support for the reform could come into existence soon. Both documents, i.e. that of August 11 and the draft brief of August 16, stress the lack of "stability of any government in the present circumstances, let alone its ability to implement an adequately strong economic program". The Round Table Agreements envisioned 'Solidarity' in the process of governing, including economy. As the July 4 elections were won entirely by Solidarity, at the end of the month its leaders with Lech Wałęsa decided to play 'va bank'. With such a strong social legitimation, Wałęsa made a proposal to the communist government that Solidarity could take all or nothing: either full responsibility for creating a government or remaining the opposition and reviewing the government's actions. As Russo noted, this tough stance of 'Solidarity' could change the political system in Poland in a very fast and radical way. Seeing it as an opportunity for a radical reform, the Fund did not want to engage wholeheartedly in the cooperation on the "more gradual approach".

For that reason, in order to gain a better social-political and financial grounds for the implementation of a radical reform, Russo came up with the solution that could reconcile the

[188] In mid-August, the Fund assumed that a communist-controlled government (not a democratic one) would soon be formed.

interests of all the three parties: the Fund, Western governments and Poland. Namely, the problems of the EC unwarranted assistance and social resistance to strong reform were to be solved by offering a "more generous and less orthodox assistance" by Western governments but only if a change in the complexion of the government in Poland took place, since only then the Western political sentiment towards Poland would change.[189]

What could the assistance of the West specified as above stand for? The August draft brief that eventually was not sent proposed to combine the implementation of the "more gradual approach" with a more generous means of conventional debt relief. It also stated that the authorities did not request the IMF help regarding debt reduction. For comparison, the October draft brief, written after the initial negotiations with the new democratic government on the strong reform, assumed that it would seek to reduce the official and private debt, while fundamental negotiations would take place in 1990. The relation between a radical reform and a considerable debt reduction was to be openly formulated by the Fund experts in a confidential document of August 17, which I analyse in the following chapter.

Moreover, the Managing Director himself spoke directly about the debt reduction in September during the private meeting dedicated to the Polish reform with representatives of the US Administration and the World Bank. He stressed that if the government chose to implement the "strong program", the Fund would take a considerable part in funding the financing gap, while the reform in this shape would require the debt reduction.[190] The description of various correlations between the strong reform and the extraordinary debt relief will be discussed in the next chapter. Here, it should be noted that by the "more generous and less orthodox official assistance" one should understand debt reduction as a condition for the success of the radical reform.

In conclusion, the revision of the trilateral cooperation model done by Russo envisaged that the new Solidarity government would allow for a radical reform to be implemented, since it would receive unorthodox financial assistance from Western countries more willing to provide it to the new *democratic* government. Also, the new government formed by 'Solidarity' would be granted social approval of a radical reform. Both factors, the financial and the political one, would strengthen the new goverment's ability to implement the adequately strong economic program. To prevent the EC/G-7 from giving fast conventional

[189] Ibid.
[190] IMF Archives, EURAI, Box 62, *Poland - Meeting with Under Secretary of State for Economic Affairs McCormack*, September 21, 1989.

financial assistance to Poland to support democratization, the Fund proposed to link the new unconventional financial assistance (which was more acceptable for the Polish government) with the "genuinely firm" reform program (which was more acceptable for the IMF) on condition that the new democratic government was created (which was more acceptable for the Paris Club).

8. Cancellation of the "more gradual approach"

As a consequence of the above trilateral cooperation scheme being adopted, the staff postponed the mission planned for September, which was to settle the details of cooperation with the government on the "more gradual approach". Here, it should be noted that in its negotiations with the communist government, the Fund had already once adopted a strategy to wait in hope for more beneficial grounds for a strong reform in Poland. This is evidenced by an annotation in the memo dated June 3, 1989 written by Deputy Managing Director Richard Erb. The document envisaged that the initial operation with Poland could take the form of the first credit tranche arrangement. It was one of the forms of the cooperation between Rakowski's government and the IMF negotiated in the first half of the year. It entailed financial support from the IMF at 25 percent of the Polish quota in return for the implementation of reforms expected by the IMF, yet with no guarantee of a stand-by agreement. On the photocopy of the original document there is a sentence added in handwiritng by Richard Erb, who recommended the mission to take time with the first credit tranche option, as it was possible that soon the "Solidarity try a stand-by for 1990 which may provide a way for proceeding."[191] On the eve of the July 4 elections that were a political earthquake in Poland and in the region, one of the key policymakers in the Fund proposed to freeze, for a time, negotiations with the Polish government. Below, I demonstrate that in August, the analogous wait-and-see strategy was adopted in hope for better political conditions for the reform.

Although the August draft brief was written for the communist government and not the Solidarity-driven one[192], by the end of August, the political situation in Poland changed radically. On August 24, one of the leaders of Solidarity Tadeusz Mazowiecki was elected

[191] IMF Archives, EURAI, Box 62, *Poland - Briefing Paper for Staff Visit,* May 31, 1989.
[192] This is evidenced by numerous references to the Ministry of Finance program or the intent of the contemporary authorities present in the briefing paper.

Prime Minister and it was announced that the new composition of his government be made public on September 10. Thus, the justification for further proceedings with the more gradual approach became obsolete, while at the same time, Russo's expectations proved realistic, laying the foundations for the new strategy towards Poland by the West.

In summer of 1989, a planned character of the IMF mission visit in Warsaw changed three times. The document of July 6 envisaged a small staff team visit in Warsaw in August ahead of the article IV consultation discussions in September. This was justified in the document with the fact that the expected government in August would be under great pressure to finalize its economic policies shortly after taking office.[193] According to the draft brief of August 16, it was assumed that if the new government (but still dominated by the communists) was formed and approved by the Parliament, a staff team would visit Warsaw on September 6-20 for the article IV consultation discussions and to resume discussions on the content of the program that could be supported by the Fund before the annual meetings. Therefore, the Fund had prepared the briefing paper which envisaged the more gradual approach.[194]

Two weeks later, the document of August 30, already after Mazowiecki was elected Prime Minister, pointed to the fact that the political situation in Poland remained fluid, and formation of a government was likely to be delayed as it was not expected to be named before the weekend of September 9-10. In these circumstances, the document assumed, it was not possible to have meaningful article IV consultations discussions before the annual meeting – which was the planned proceedings under the more gradual approach. In the Fund's calculations, the new and most probably democratic government meant a new social-political system where the possibilities for conducting an economic reform would change. As Russo wrote to the Mangaing Director, "in situation being as it is, it would seem to me all the more important that we be in contact with senior ministers promptly after a government has been formed. [...] In the circumstances, I have decided to withhold the August briefing paper that envisaged more gradual approach, so that when we send the briefing to you for approval, it contains the results of our proposed visit."[195] [...] Accordingly, Russo asked for a permission to visit Warsaw accompanied by Peter Hole on September 17-20. The aim of the visit would be to conduct preliminary negotiations preceeding proper negotiations under the framework of the IV consultation discussions in October in order to sound out the new government in terms of its willingness and determination to carry out the "strong reform".

[193] IMF Archives [...], *Poland*, P. De Fontanay to the Managing Director, July 6, 1989.
[194] IMF Archives [...], *Poland*, M. Russo to the Managing Director, August 30, 1989.
[195] Ibid.

However, where does the assumption that the Solidarity government would be more likely to conduct the reform in line with the IMF expectations come from? Unquestionably, the mission could assume that the Solidarity government would have social support for the economic reform carried out in cooperation with the IMF. According to the Fund, only such government could withstand the pressures that would inevitably emerge with the reform implementation to make financial policies less stringent.[196] The IMF withheld the program with the communist government not because it was violating human rights, but because it was not credible in the country and that translated into a lack of political feasability and viability of economic reform, including the more gradual approach. Two waves of strikes in 1988 proved unquestionably that the 'social' barrier existed and that the communists were unable to handle it. For the IMF, the Solidarity government ensured social consent to radical economic reforms, which was the 'iron' condition for the reform to succeed.

Another condition was the new government's approval of adopting a 'rapid approach' in reforming the economy. Until that time, official statements of 'Solidarity' leaders regarding the shape of the future economic reform did not bode well for good cooperation with the Fund. It suffices to recall the Round Table agreements and the June appeal in Brussels to the West for financial aid.[197] However, in August, the Fund had some reasons to believe that the new government would prove more eager to cooperate than the communist one. This did not pertain only to the elimination of the above-described social resistance. In the justification for the decision on withholding the "more gradual approach mission', Russo wrote to the Managing Director of the IMF that "whatever the pace of reform, some compression of living standards must be expected initially. The initial economic downturn would almost certainly be sharper, the stronger is the program." He then went on to remark that "press reports indicate that these issues are actively debated within Solidarity with support developing for the bolder approach amongst its economic advisors."[198]

At that time, the leaders of 'Solidarity' indeed were more in favor of the shock therapy. In early summer, future foreign advisers to Balcerowicz Jeffrey Sachs and David Lipton paid a visit in Warsaw to convince in separate negotiations the leaders of 'Solidarity' - Jacek Kuroń,

[196] Ibid.

[197] Importantly, although the appeal was written by Witold Trzeciakowski, Solidarity's key economic expert, it also gave rise to a highly critical response among economists closely related with 'Solidarity', such as Stanisław Gomułka or Jacek Rostowski.

[198] IMF Archives, EURAI, Box 62, *Poland*. M. Russo to the Managing Director, August 30, 1989.

Bronisław Geremek and Adam Michnik[199] - to support a radical reform due to the lack of any real alternative. The IMF document dated September 12 confirms the permanent effect of the influence exerted by both economists on the leaders of 'Solidarity', noting that their proposals for a shock liberalization plan received wide publicity in the Polish media.[200] The radicalization of Kuroń's economic views was also evidenced by the last of his "Ten theses" on the necessity to follow a radical reform. The thesis in question read as follows: "In the case of our government, we should opt for a quick, one-time transition to a market economy. In the case of a coalition government under our control - we should rather think about a gradual transition."[201]

Less than a week after the new government was formed with the Prime Minister and most ministers from 'Solidarity' two events took place that sealed the cooperation model outlined by Russo in the document of August 11. First, the announced two-person visit of the Fund to Warsaw occurred on September 17-20. On September 20, Polish delegates met in Paris with the Paris Club. The message received by the former during both these meetings boiled down to this: if the government decided on the radical reform (stricter than the more gradual approach), the Fund and the Club would close the enormous financing gap on the way to implement the reform.

This message was communicated to the government in an indirect manner on September 20 at the meeting in Paris where the Paris Club representatives made it clear that the Poles could not expect any kind of special concessions in the rescheduling agreement. They stuck to the standard line that Poland needed to get an arrangement with the Fund, after which the rescheduling could take place. This stance of Western governments was to the satisfaction of the IMF due to its interest to prevent the granting of a substantial debt relief before making an agreement with Poland. An IMF representative present at the meeting drew attention to the already mentioned factor that was to the Fund's advantage, that is a lack of unanimity

[199] Jacek Kuroń (1934-2004) was one of the most important social activists and representatives of the political opposition in the communist Poland. He was widely known as the "godfather of the Polish opposition", and was one of the founders of the Workers' Defence Committee (KOR), the forerunner of 'Solidarity'. Bronisław Geremek (1932-2008) was a medieval historian. He was, next to Kuroń, the leading figure in the Polish democratic opposition during the communist era. Throughout the 1980s, he was the key adviser to 'Solidarity' and Lech Wałęsa. Adam Michnik (1946 -) is a historian and journalist. He was one of the leaders of 'Solidarity', and after 1989 he became one of the most influential figures in democratic Poland. According to some accounts of the meetings between the 'Solidarity' leaders and Sachs-Lipon duo, each of the three leaders admitted having poor knowledge about economics but all were impressed and convinced by a straightforward and clear message delivered by the American economists [Sachs J., *The End of Poverty*, Soros G. *Underwriting Democracy*; Kieżun W. *Patologia Transformacji* (*The Transformation Pathology)*].

[200] IMF Archives, EURAI, Box 62. *Poland--Staff Visit (August 30-September 7, 1989*), September 12, 1989.

[201] Domarańczyk Z., *100 dni Mazowieckiego* [A hundred days of Mazowiecki]; p. 45.

between the Club members who continued debating on whether or not a Fund arrangement was an absolute prerequisite. This lack of consensus in the Club, not to mention varying interests of hundreds of private banks, substantially compromised creditors' ability to dictate conditions for the cooperation with Poland. Hence, they relinquished this matter to the IMF.

At the time when the Polish delegates were becoming disillusioned as to the possible cooperation with the Paris Club in the form of the interim rescheduling and were implicitly advised by the Club to reach an early agreement with the Fund, the very same message, though in a direct way, was transmitted to representatives of the Polish government by Massimo Russo. In a memo to the Managing Director dated September 22, he stressed the fact that the government was informed that if the discussions were to proceed well, and a "strong and plausible program" could be negotiated, the Fund management's informal approval might be obtainable in November, which would enable the Fund staff to help Poland in closing the financing gap and securing the needed foreign assistance from other creditors.[202]

Until that time, Poland encountered an intractable obstacle of being unable to come into agreement on the matter of payments neither with the Club nor private banks, and it was the condition set by the Fund for concluding the stand-by program. Then, the Fund made the situation easier for Poland by telling directly that if it agreed to the restrictive program, the IMF would ensure unconventional financial assistance from creditors. That reform was the only means for the government to gain credibility in the eyes of the IMF, while cooperation with the Fund was a path towards credibility for Poland's creditors. In this way, Poland was made aware of the fact that only the radical economic program could solve the vicious circle of the negotiations with creditors.

9. Polish perspective: how to become credible?

Together with the liberalization of the political life in Poland chances for an agreement with the IMF increased and the Polish government was faced with the task of re-evaluating the former model of relations with Western creditors. This was required under the principle of parity of treatment of various groups of creditors, which determined the creditors' approval of granting debt service relief for the time of the reform. The need for gaining credibility in the

[202] IMF Archives [...], *Poland*, M. Russo to Managing Director, September 22, 1989.

eyes of Western governments was particularly strong in the democratic government that from the outset declared a pro-European course both in foreign and economic policy.

Credibility in the eyes of the West was essential for the new authorities, since in the 1980s, Poland was probably the only debtor in the world that remained in a chronic state of technical default towards the Paris Club. This was due to the political origin of the economic crisis in Poland. Like I tried to show in the first chapter, since martial law was declared in Poland on the last days of 1981, Western governments consistently isolated Poland by means of the credit blockade, while the communist government replied by being insolvent to the Paris Club, which was announced unofficially and persisted until the end of the decade. Despite a number of the debt agreements concluded with the Club, until 1989 Poland failed to satisfy any of them. Since the interests under these agreements were not paid on time, this gave rise to liabilities that were then added to the debt stock, which substantially increased the nominal value of the Polish foreign debt. The World Bank data[203] showed that between 1985 and 1989, total debt service paid by Poland on its bilateral official debt – both principal and interest - never exceeded 4.4 percent of the debt's face value. These payments were well below Poland's official debt service obligations. However, by 1989, the debt service to bilateral official creditors fell to 1 percent of the debt's face value.[204]

What is more, neither the peaceful sharing of power between the communist government and the opposition nor the forming of the democratic government with the Prime Minister from 'Solidarity' translated into Poland's increased financial credibility. Already in early October 1989, the future Fund representative in Poland Mark Allen wrote to his superiors that "most Paris Club creditors took the position during the recent meetings that Poland is not creditworthy."[205] Furthermore, the democratization caused the Poland/Paris Club stalemate to aggravate. This was due to the fact that for the first time in years, the pro-Western turn of the new government made the issue of Poland's enormous contractual obligations toward Western governments clear and public. Unfortunately, it was exactly in 1989 when Poland conducted pioneering democratic changes that the situation of its liabilities to the Paris Club was much worse than it was for the communists.

The greatest problem for the new government to tackle was the contractual level of debt service, i.e. payments due on account of the debt rescheduling agreements concluded in the

[203] Wertman P., *The Polish Official Debt Accord, A Problem of Containment*; p.6.
[204] Ibid; p.9.
[205] IMF Archives, EURAI, Box 62. *Poland--Financing Strategies, Debt Reduction and the Commercial Banks* , October 1989.

1980s. Nevertheless, Poland's liabilities determined under these agreements pertained not only to arrears that accumulated until 1989 that were practically not paid by the communist authorities. A greater threat to the new government was an accumulation of payments that began with the end of grace periods for two agreements concluded in 1985 and one from 1986. In total, the amounts payable under these three agreements were estimated at over 14 billion dollars over a five-year period starting from 1990. Payments due 1990 increased by about 2 billion dollars, while further payments were to gradually increase over the subsequent years.[206] This posed a threat of a second wave of accumulated payments in the last 10 years, similar to that tackled by the Polish government in the years 1980-1981. As described in the first chater, at that time the communist authorities declared insolvency while Western governments and banks decided to give Poland financial relief in fear of the 'domino effect' in the region, which could undermine the stability of the financial system in Western Europe. With the beginning of the year 1989, Poland's insolvency was a commonly known fact in the West that shocked no one. However, a question arose as to whether the change of the political system itself justified helping Poland out of the debt crisis or should Poland's creditworthiness come from yet another direction?

There were several reasons why the new democratic and pro-Western government had to arrive at a settlement with western official, and not private, creditors on contractual obligations concluded by former communist governments. Firstly, the new government intended to conduct an economic reform that was conditioned on financial support from Western governments. Otherwise, if the government wanted to pay current liabilities arising from the existing agreements to restore international financial credibility, it would have had to meet a crushing level of debt service payments while trying to stabilize Poland's economy and restore domestic economic growth. Secondly, the IMF traditionally demanded a debtor to have a clear account in relations with all groups of creditors for the duration of the stabilization operation, since the internal reform could not take place at the expense of aggravated external imbalance. In the case of Poland, this meant giving priority to negotiations with the Paris Club over private Western banks due to the fact that over two-thirds of Poland's debt was owed to Western governments.

More importantly, the new government made a strategic turn in its foreign policy towards integration with democratic and capitalist countries. This meant that it had to prove its

[206] Antonowska-Bartosiewicz, L., Małecki, W., *Zadłużenie zagraniczne Polski do końca 1991 [Poland's foreign debt by 1991]*.

credibility towards them in the first place. Hitherto, the communists had ignored the issue of payments to the Paris Club, focusing on maintaining good relations with private banks, as they knew it was the only source from which they could incur even small credits.[207] The communists paid minimum amounts to Western official creditors only to prevent themselves from being declared completely insolvent. On the one hand, the problem of relations with the Paris Club was hence frozen in the 1980s. On the other, paradoxically, Poland's relations with private and government creditors can be considered stable owing to this strategy adopted by General Jaruzelski's regime. This stabilization meant relatively predictable good relations with banks. Although it did not create any opportunity for credits from Western governments, it prevented them from formally decalring Poland in default.

At the end of 1989, both the IMF and the government realized this transitional strategy could not be continued. The democratic government had to 'answer' for the communists' debts and gain credibility in the eyes of Western states after concluding the debt agreements for years by the communists who did not satisfy their provisions. The government could not proceed to the implementation of the reform, ignoring past and subsequent 'contractual' payments to the Paris Club. In turn, the Fund intended to make Western private banks aware of the fact that the role of the Paris Club in the general politics of Poland greatly increased with the formation of the democratic government and that banks could not count on preferential treatment anymore.[208]

Although this was the eventual outcome, neither the Fund nor Poland intended to privilege governments over banks. On the contrary, the fundamental requirement of international financial institutions each indebted country had to meet was to ensure more or less equal treatment between groups of creditors. Unlike before, in 1989 the new Polish government faced a very difficult challenge: on the one hand, to reestablish good relations with official creditors to whom it had gigantic arrears that accumulated over the years, while on the other – to maintain payment capacity with regard to banks. What is worse, in the fall of 1989, its ability to fulfil even the smallest liabilities fell to the minimum level. Interestingly, it was this very dramatic financial situation of the country that brought a solution to the problem of the parity of treatment. Due to the negligible level of operational reserves on the accounts of the National Bank of Poland, the Polish government informed banks in September that mid- and long-term interest payments were to be ceased. Together with a former suspension of capital

[207] IMF Archives, EURAI, Box 61, *Poland--Staff Visit. Meeting, no. 13*. June 18, 1989.
[208] IMF Archives, EURAI, Box 62, *Poland. Debt-Service Reduction*, M. Allen to M. Russo, October 10, 1989.

payments by banks for the period of 1989-1990, this situation meant lack of any payments on the part of Poland, the inevitable consequence of which was an accumulation of arrears to commercial creditors.

Concerning the above, the IMF pressured private banks to make then financing assurances in the form of a partial financing of Poland's debt reduction, which was quite unfortunate, and to refinance mid- and long-term interests formerly reduced by half, which would allow Poland to partially pay interests for the Paris Club. In short, banks were expected "to take a hit and get new exposure simultaneously."[209] The banks claimed they could grant Poland refinancing loans only when given guarantees from Western governments. However, this implied a return to the starting point. The refusal of refinancing was perceived by the Fund as "another case for going ahead without banks."[210] The priority treatment of the Paris Club was also justified for other reasons. In line with suggestions coming from private banks, Poland's debt reduction could become a subject of dispute only if the Paris Club made the debt reduction first.[211] Besides, in fall, the IMF received an initial confirmation from Western governments regarding the extension of Toronto Terms. envisioning outright reduction for low-income countries, also for heavily indebted countries with a higher GDP per capita.[212]

The issue of ensuring financial assistance for the Polish reform program was openly presented during a meeting of Paris Club in November. The representative of the West German government Michael Graf von Korff proposed on the forum of the Club to grant a very generous rescheduling to Poland on the condition that it suspended all payments to private banks.[213] This solution was welcomed by other representatives of the Club. According to Von Korff's report, the Chancellor of Germany was to call the senior representatives of Dresdner Bank to present the above agreements as a *fait accompli*, much to their indignation. Thus, the parity of treatment principle turned into an option of ceasing payments to both groups of creditors.

From then on, the Polish government was expected to become credible to its creditors not by means of paying moratorium interest – as stated even a few months earlier – but by implementing the "strong program" in cooperation with the IMF. As already mentioned, the Polish government was previously informed several times by the staff team about the fact that

[209] IMF Archives [...], *Poland-Financing Strategies, Debt Reduction and the Commercial Banks* , October 3,1989.
[210] Ibid.
[211] IMF Archives, EURAI, Box 61, *Poland* , Jim Prust to Massimo Russo, May 17, 1989.
[212] Ibid.
[213] IMF Archives, EURAI, Box 63, *Poland,* P. Hole, November, 16, 1989.

if it agreed to the radical option of the reform, the Fund would make a deal with the creditors regarding the external financing. In September, Russo specified this stance by saying that if the negotiations with the Polish government proceeded well between October and December, the IMF delegates would go to Paris, Washington, Brussels and London at the same time to negotiate the financing of the Polish reform with the creditors.[214]

As I have stressed when discussing the track record, the sole commitment of the new government to implement the strong reform was not enough. The Fund and the creditors expected specific actions in the economy that would confirm the authenticity of the Polish government's intentions. This was provided by the first round of strong stabilization measures introduced by the government from the end of September 1989.

10. Track record in action

In the fourth quarter of 1989, the new democratic government conducted a strong and rapid stabilization operation that the IMF and the creditors demanded for months. Below, I would like to prove that the actions taken by the government in the area of economic stabilization at the end of the year intended to demonstrate its credibility on the international arena to gain financial support for the reform that was to be launched with the first day of the new year.

When on September 20 the Paris Club rejected the possibility to enter into the interim agreement with Poland, this was a consequence of the new strategy in trilateral relations, in accordance with which the agreement with creditors could not take effect before an agreement was concluded with the IMF, which, in turn, depended on a former introduction of the track record by the Polish government. This meant that one of the three conditions for a stand-by agreement mentioned in the early 1989, i.e. aside from the track record and social consensus – the settlement with the Paris Club was beyond the diplomatic capabilities of Poland. The path to fulfilling this requirement led through decisive actions in the field of macrostabilization intended to stop the economic crisis that was aggravating with each day.

The unique and extraordinary determination of the new democratic government to conduct the radical change in the economy was emphasized by the vice president of the Central Bank

[214] *Sprawozdanie z rozmów przeprowadzonych w dniach 16.10- 15.11 br. z misją MFW*, 20.11.1989 [Note on the negotiations conducted with the IMF mission between October 16 and November 15, 1989], November 20, 1989. Archives of the Ministry of Finance, Warsaw.

Andrzej Olechowski in his speech at the meeting of UNCTAD on October 4, 1989. When addressing the president of the UNCTAD, he stressed that the new government did everything in its power to ensure that the reform was a success: devised a reform program with the IMF, obtained the "universal support" of the population, attained a political consensus on that issue, and it was currently conducting the initial phase of macroeconomic stabilization with visible effects. However, he added that "to be certain of our success we need one more element - a hefty measure of international support", and specified in a moment that "of particular relevance for us is the debate on interdependence and debt."[215] This way, Olechowski wanted to deprive the West of the argument that Poland had to do something on its own before seeking any form of debt relief once again. Now, the success of the Polish reform depended on the creditors, since the government had done everything in its capacity to provide proper conditions for the reform.

The government's convincing start of the stabilization operation made it credible enough in the eyes of the creditors and the IMF. As a result, at the end of October Western governments granted their approval for the suspension of Poland's outstanding payments for the last months of the year. As for the rescheduling of payments due in 1990, the governments remained reluctant to reschedule Poland's debt before the IMF stamped its seal of approval on the reform.[216]

In November, seeing that there was no consensus in the government on a matter of fundamental importance, i.e. the pace of the reform, the IMF mission referred to past public pronouncements of the government on international forum. Most likely, the issue in question was the Polish government's appeal to Western governments on external assistance, which was made at the end of September. The new Polish government emphasized at that time its commitment to transform Polish economy into a market economy, interlinked with the world at large and marked by a diversified ownership structure. To this end, as the government stressed, it was determined to introduce a program of quick economic changes.[217] Therefore, in November, the Fund experts drew attention of the government representatives to the fact that a bolder action would be more in keeping with the Government's credibility, "as well as with the expectations of external creditors."[218] Representatives of the Polish government had

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[215] IMF Archives, Poland, Correspondence and Memos, Box 62, October 1989, *Statement by Andrzej Olechowski at the 36 Session of UNCTA*, October 4, 1989.
[216] Reuters, 24 October, 1989.
[217] IMF Archives, Poland, Correspondence and Memos, August-September 1989, *Memorandum Of Polish Government Concerning The Needs In External Assistance*, September 26, 1989.
[218] IMF Archives, EURAI, Box 63, *Poland*, M. Russo to Managing Director, November 13, 1989.

no doubts in the creditors' expectations pertaining to the pace of the reform as the IMF mission reminded them that at the time they were prisoners of promises they once made.[219]

The outcome of the stabilization actions in the fourth quarter of 1989 was a noticeable improvement in macroeconomic indicators: elimination of excess liquidity, i.e. a monetary overhang that 'consumed' the value of money in people's hands; decreasing inflation rates from a level close to hyperinflation to 15 percent in December; stopping deficit from growing, which was at about 10 percent of GDP in September and 7.5 percent of GDP in December; starting systemic changes in the form of subsidy restrictions and price liberalization. However, it was not the scale of adjustment that was of the key importance here, but the demonstration of the government's determination and a social approval for the radical changes. For the Fund, the track record was also a substitute and a benchmark of enforceability of the reform planned for the following year. Moreover, the successfully implemented track record constituted a clear signal from the government to the creditors: 'we want to, and we can overcome domestic imbalance, but real economy is still ailing and large current account deficit persists, while the level of reserves is at a minimum. Hence, we expect the foreign debt burden to be decreased, as it is an obstacle on the way toward economic stabilization'.

Poland was ensured that this message was properly deciphered by the creditors by Michel Camdessus, the Managing Director of the IMF[220], during a several days' long visit in Warsaw in the middle of December 1989. Already at the very beginning of a meeting with Lech Wałęsa and Andrzej Stelmachowski[221] he stated that although "the challenge was formidable and the next six to nine months will be tremendously difficult, Poland will succeed because she has shown what it can do and will have strong support from the rest of the world."[222] Regardless of this declaration, Stelmachowski stressed the government's determination and perseverance in stabilizing the economy, and demanded that the Fund abandoned the "wait

[219] Contrary to what the government claimed regarding a consensus on the reform, it was divided on the matter of the pace of the reform. Balcerowicz and the president of the Central Bank Władysław Baka defended the need for a rapid suppression of inflation, while the former leaders of 'Solidarity' such as Mazowiecki, Geremek and Trzeciakowski were enthusiasts of a slower pace.
[220] Michel Camdessus (1933 -), a French economist. During the period 1978-1984, he was the Chairman of the Paris Club. In 1987, he became the IMF's Managing Director and held this post until 2000, which made him the longest serving Managing Director in the IMF history. During his tenure, the Fund entered a period of splendor (putting an end to the global debt crisis of the 1980s; supervising economic transformation of the post-communist countries in the first half of the 1990s), but also lost much of its international prestige (mismanagement of the East Asian crisis in 1997).
[221] The Marshal of the Polish Senate in 1989–1991.
[222] IMF Archives, EURAI, Box 64, *Summary paraphrase of meeting between the Managing Director and Mr. Walesa, Chairman of Solidarity*, 9-11 December 1989.

and see" approach. This reaction proves that the authorities were frustrated with the Fund's inaction and West's precautionary stance on the matter of granting financial aid to Poland. Camdessus himself strictly objected an idea that the Fund adopted the 'wait and see' approach in regard to events in Poland. To justify his stance, he named three initiatives he himself intended to bring on on the following days: at meetings in Brussels, he wanted to transform the Polish list of intentions of foreign aid into real payments; he wanted to agree as soon as possible with the government on a program that would serve as the basis for a stand-by credit planned for January, which subsequently "would clear the way for the Paris Club"[223] to proceed with a rescheduling for 1990.

The financial support from the West did not mean only food aid (to maintain consumption), new credits (for imports) or debt rescheduling (for the needs of smooth realization of an economic reform not hampered by external payments). The rapidity, determination and effectiveness of the government, proved in the fourth quarter of 1989 in stabilizing economy, intended also to convince the creditors to establish a Stabilization Fund of 1 billion dollars. This was a new aspect of the assistance from the West, as it pertained to a form of financing serving as a condition for the success of the stabilization phase of the reform. The Stabilization Fund was an inherent element and condition for success of the stand-by program, to strengthen Poland's convertible currency reserves and, more importantly, to ensure the convertibility of the *zloty*. As several years later one of the IMF representatives wrote, without the evidence of the Government's commitment to tight financial policies from the fourth quarter of 1989, "creditors would have been reluctant to assemble the stabilization fund".[224]

In this thesis, I will try to prove that in the most dramatic periods of the several years' long cooperation between the Polish government and the IMF, the direct dependence between decisive actions in the field of macroeconomic stabilization and a perspective of obtaining the debt reduction was decisive for the continuance of the reform started in 1989.

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At the end of August 1989, Leszek Balcerowicz specified as the condition for taking the post of Minister of Finance and Vice Prime Minister an approval of a radical anti-inflationary operation. In this regard, he completely supported the IMF opinion that only decisive and rapid suppression of inflation that entailed broad and coordinated stabilization operation

[223] Ibid.
[224] IMF Archives, Poland 1993, Desmond Lachman, *Poland - 1990 Stabilization Fund*, July 16, 1993.

would be effective and form grounds for the radical systemic reform. In line with this view, application of a phased approach to fight inflation could have an opposite effect in the form of deeply grounded inflationary expectations, since this approach would be perceived only as an evidence of the government's lack of faith that rapid recovery of economy was possible.

In broader terms, however, it can be said that it was only the approval of the radical transformation reform that could pull Poland out of the debt crisis that had continued from 1981. Paradoxically, the choice of this variant of the reform alleviated the new government from the burden of tackling the debt crisis and the economic crisis simultaneously. Only the shock therapy created the opportunity (yet not a guarantee) for a *permanent* solution to the external imbalance problem. The radical domestic reform, which gave priority to a reduction of rapid inflation, allowed for the Fund adjustment programs' 'essential' condition of early balancing of current accounts to be not applied. The several years' long deep structural stabilization of the economy meant that external balance had to be ensured by the creditors not only temporarily for the period of a first phase of the reform, i.e. the macroeconomic stabilization. If the reform was to result in inflation stabilization, permanent increase in economic activity, forming of systemic brakes for expansive budget policy or providing grounds for market mechanisms, then the Western financing assistance had to be adequate enough to make external imbalance not inhibit a stabilization-cum-systemic reform. Already before the formation of Mazowiecki's government, the IMF management came to a conclusion that this reform had to be supported by a considerable scale of both official and private debt reduction. The types of correlations between the radical transformation reform in Poland and the need for the radical solution to the foreign debt issue are analyzed in the next chapter.

Chapter III. Correlations between debt reduction and rapid transition

In the previous chapter, I made an effort to show how the origins of the shock therapy in Poland looked like from the view of the Western institutions (the IMF and the Paris Club). The key factor that made overcoming the stalemates in the negotiations on debt reduction and economic reform possible was the change in the political situation in Poland. But for this change to occur, the unconventional debt relief had to be linked with Poland's obligation to conduct a strong reform. The economic program of the new governement was declared on October 6, 1989 and left no room for doubts regarding the 'shock'-like nature of upcoming economic changes in Poland. Was the perspective of Western external assistance equally clear?

In no conversation with the authors of the economic reform nor in any document from that period did I find a confirmation of the thesis that Poland was to receive from the West the debt reduction offer in exchange for conduting radical economic reform. This deal would be impossible to implement on the part of the IMF. Firstly, the Fund failed to get the initial consent of Poland's creditors for debt reduction before the launch of the reform. Secondly, the most important issue was whether the economic reform started as soon as possible, which involved a need for the prospective external financing gap to be closed expeditiously. Therefore, the authorities together with the IMF decided not to opt to seek a reduction in debt or debt service in 1990.[225] Thirdly, the IMF had a more difficult task to deal with in the case of cooperation with Poland than with other member states.

On the one hand, the Fund was a zealous advocate of an unprecedented Polish reform and supported it consistently in the following years, yet on the other, this support was inistitutionally limited. Executive Directors from the Executive Board, which carried out the day-to-day work of the IMF, were mainly representatives of the Paris Club, which was openly reluctant to support the debt reduction initiative. The Fund had to take care of its prestige of a major international financial institution and for this very reason, although it considered the debt reduction a condition for the Polish reform to succeed, it could not give full support for Poland in negotiations with the Club. Indeed, it was well aware of the fact that the latter was

[225] IMF Archives, Country Files, Box 63, *Poland* , M. Russo to Managing Director, November 13, 1989.

dependent on „the say-so of the Fund staff" on the matter of debt reduction.[226] In turn, it can be said with all certainty, that external support scenarios developed by the IMF experts unambiguously indicated that debt reduction was an option only if the choice of the rapid transition reform was approved, although the implementation of this variant did not guarantee debt reduction by any means.

Even given the radical reform scenario, this uncertainty of debt reduction was confirmed by difficulties encountered by Polish delegates in negotiations with the Paris Club in 1990. Despite the implementation of the most radical version of the reform, Western states consistently avoided discussions on the debt reduction until the fall of 1990. After all, in one of its 1989 August documents, the Fund provided for a combination of radical reform and financial assistance that would not entail debt reduction.

Earlier, in May 1989, the chief of the IMF mission in Poland Jim Prust expressed doubts whether the extraordinary debt relief was inseparably linked to a rapid transition, that is, to the fast macroeconomic stabilization-cum-systemic reform. In a conversation with George Soros, Prust expressed his doubts whether this very „grand design" proposed by the former could be implemented, grounding his concerns on the fact that people in Poland were not that desperate to accept the reform that is so radical. More importantly, he believed that a three-year moratorium on interest payments to the Paris Club proposed by Soros and, thereafter, a conversion of the official debt into equity shares in Polish enterprises was not at all more likely to take place under the „grand design" scenario than under a more orthodox one.[227] Although Prust's skepticism stemmed from his aversion to the shock therapy in Poland, and Poles' tolerance to the 'shock treatment' proved higher than he had expected, still, his personal views were a good reflection of problems experienced by Poland and the IMF in their efforts to convince the creditors to the debt reduction on a scale that was more than conventional.

In a joint action for debt reduction, Poland and the IMF most often used three types of arguments.[228] Economic arguments supporting the need for the debt reduction referred to an objective economic situation that the radical (and only radical) variant of the reform could

[226] IMF Archives, Country Files, Box 62, *Mark Allen: Poland-Possible Format of Paris Club Agreement*, June 19, 1990.
[227] IMF Archives, Country Files, Box 62, *Poland - Mr. George Soros's "Plan to Solve the Economic Crisis in Poland*, May 25, 1989.
[228] Polish negotiators used also historical and social arguments. They justified reduction of the Polish debt by referring to the precedents, particularly the reduction of Germany's debt after World War II. The also stressed that Polish society deserved debt reduction by patiently waiting out when their belt was tightened.

create. According to this, debt reduction was necessary for two reasons: first, because a response of economy to the reform was by far more unpredictable and uncertain than in the case of other programs, and secondly, because a radical reform would surely hit real economy considerably stronger than a gradual reform would. The economic arguments had a lesser impact on the final decisions of the Paris Club compared to the other two types of arguments. However, only those could provide the essential formal justification for the debt reduction in official addresses delivered by representatives of the IMF and the Polish government. After all, in the case of Poland, they were more convincing than in the case of other highly indebted states.

Aside from the economic arguments, there were also political arguments supporting debt reduction that were inseparably linked to the reform implemented in Poland. The first one was officialy accentuated by Poland in the form of undertaking the unique economic reform aimed at building a free market economic system modeled on Western countries. The second political argument – one used by IMF representatives – for extra financial assistance for Poland stemmed from the need for the Fund to succeed in Poland specifically, so that in this way an example was formed for other transforming countries in the region to follow. This ‘regional effect’ of a radical reform was also stressed by Poland. It resulted from the fact that the main group of Poland’s creditors were Western governments, which by necessity paid attention to regional implications of whether the reform in Poland succeeded or not. Lastly, the third type of argument stemmed from the IMF being concerned about safety of its own resources engaged in the Polish program. By highlighting an exceptional risk involved in the implementation of strong reform in Poland, the Fund expected Western governments to grant additional guarantees for the success of the reform in the form of the debt reduction.

1. Economic criteria for debt reduction

1) Political origins of debt reduction

Above I depicted the Fund’s offensive towards West European governments regarding taking over coordination of the strategy towards Poland. It stemmed from a concern that the revolutionary political shifts in Poland would lead to a rapid granting of financial aid to Poland, which in turn would make the fundamental economic reform impossible. Western governments’ assistance for Poland was also called by the Fund a ‘political money’ due to the fact that it was intended to provide support to the democratization process. The Fund wanted to use this unique readiness of the West to provide financial support to create conditions for the strong reform. First, in June 1989, it assumed that with the perspective of a stand-by credit and additional financial support from Western governments, it would succeed in convincing Polish authorities and society to go for the strong domestic reform. In turn, the Fund's offensive outlined in August aimed at convincing Western governments to stop providing aid to Poland, since a pro-West democratic government can be established there soon. Once such a government was formed – as the Fund assumed – the Paris Club countries would be more likely to grant it unorthodox assistance that would increase Poland's motivation to conduct a radical reform.

This line of events indicates a political origin of the debt reduction. Although the word 'reduction' does not appear in the August strategy developed by the Fund, it must have referred to the debt reduction, as the threat of chances for the strong reform being damaged by the generous rescheduling and new credits of the Paris Club countries became more and more real. The political origins of the debt reduction concept were also indicated in the above analyzed document of August 11, in which Massimo Russo outlined the new strategy. By pointing to the risk of the initiative to support Poland being taken over by the European Community and the related acceptance of the insufficiently strong economic program by the Polish government, Russo expressed the need to continue to be as cooperative as possible with Polish officials and "to prepare the ground thoroughly on the basis of alternative assumptions regarding external support."[229] In other words, in the face of upcoming situation of granting Poland the 'political money', the Fund wanted to prepare and then present to Poland several possible scenarios concerning the scale of external support.

Therefore, the "less orthodox and more generous assistance" option was justified *politically*. The proposal of debt reduction was born as a result of the political dynamics in Poland. The Fund assumed the chain of events 'Solidarity government – debt reduction – strong reform' as more real and beneficial than 'communist government – generous rescheduling – more gradual approach'. Before the 'Solidarity' government was founded, the government debt reduction was not seriously or officially discussed by either side. Nevertheless, already in August, the Fund experts devised the economic justification for the reduction in the form of alternative assumptions regarding mid-term external support.

[229] IMF Archives, Country Files, Box 62. *Poland,* Massimo Russo to the Managing Director, August 11, 1989.

2) Argument one: disastrous effects on output and society

The draft brief of August 16 envisioned mid-term external support scenarios to be presented to Poland. Although this draft proposed the more gradual approach, it assumed at the same time that the actual variant of the reform (rapid or phased) would be discussed once the IMF mission presented the mid-term scenarios to Poland. A debt reduction scenario as part of the strong program was referred to directly for the first time in a document of August 17 entitled "Poland – Medium Term Scenarios". The document discussed four variants of the reform and financial support they entail. Neither of the two variants of 'phased approach' provided for an official and private debt reduction, and it was stated unambiguously that such a reduction would be possible only in the case of the 'rapid approach'. The other variant of the rapid approach provided for rescheduling and new money, and possibly private debt reduction.

As a justification for the debt reduction scenario, authors of the document specified the influence that would be exerted by a radical reform on the forming of the GDP.[230] Already in August, the IMF (before the shift of power in Poland) assumed that in 1990 production would fall radically in the 'rapid scenarios' while the 'phased' scenarios provided for economic stagnation. In turn, over the following years, the GDP growth will be greater or smaller, respectively. What is more, current account balance will be corrected sooner, for already in 1991, in the case of the phased approach, and in 1992 in the case where the rapid approach is implemented.

This means that the phased approach did not provide for a shock-like and deep decrease in real wages, production, investments, unemployment growth, etc., but a gradual and moderate one. Thus, financing needs for social safety net would be relatively smaller. Moreover, since in the gradual scenario production did not decrease, it would be possible to correct current account balances sooner. In turn, the only scenario that provided for the rapid reform plus both official and private debt reduction envisaged decreased production and increased imports in 1990-1992 compared to the other three scenarios. However, in the medium term, this scenario offered the best perspective for the Polish economy and for the shaping of debt indicators such as debt service and debt/GDP ratios.

Due to lesser social difficulties, financing needs in the gradual variant did not require as large financial support as in the radical variant. An alternative emerged: either 'early current account balance-phased approach-generous conventional debt relief' or 'late current account

[230] Ibid.

balance-rapid approach-debt reduction'. The first scenario ensured creditors that Poland would be solvent in the short term, yet in the long run, the old debt would grow even bigger. The second scenario did not provide for Poland to restore its payment capacity in either short or even medium term, yet it assumed it would reach it in the long run (after 1994) under the conditions of a sustained economic growth and, primarily, its debt being adjusted to the payment capacity of the economy owing to the granted debt reduction. The risk of the second scenario lay in the fact that it was less certain, more hazardous than the first one. It was expected to bring results in the long term and only if debt reduction was granted. Still, economic growth assumed as the basis for improved payment capacity could take place considerably later than envisaged in these scenarios.

When ultimately the scenario assuming rapid approach supported with official and private debt reduction was chosen, the IMF accepted these very 'grave risks' related to this variant of the reform as the basic justification of granting debt reduction to Poland. This argument was accepted, since the second of the above-presented radical variants assumed possibility to support the reform through new money and rescheduling. Hence, debt reduction was not an essential condition for the radical reform. This makes the opposition of the Paris Club against granting such an exceptional reform support as debt reduction more understandable. The Polish government faced a long and difficult path leading to obtaining substantial debt reduction, with the decisive arguments stemming from other grounds than economic ones.

3) Argument two: unpredictability of the reform

The second type of economic argumentation, apart from the drastic scale of internal adjustment justifying debt reduction, entailed emphasizing uncertainty regarding the course and outcomes of a radical reform in Poland. This uncertainty stemmed from the unique nature of the reform, which meant that until that time there was no case of a country shifting from one economic system to another at such a great pace. The aspect of unpredictability of economic processes as a result of the Polish reform was indicated by Michel Camdessus and his guests at a September meeting in the headquarters of the IMF. For them, it was clear that the need for financing would depend on the pace of the reforms, and that there were unusually large imponderables in the case of Poland, for example with respect to the supply response of the economy and the availability of foreign currency holdings in the private sector.[231]

[231] IMF Archives, Country Files, Box 62, August-September 1989.

This uncertainty justified the need for additional financial support for closing the financing gap such a reform would create. However, the uncertainty argument could be referred to only with regard to the implementation of the radical scenario. The phased approach gave the Fund no sufficiently strong justification for seeking support of the Paris Club in the form of a complete debt reduction, i.e. both private and offical. Moreover, the support granted by the Fund to the Polish SBA program at the level of 80 percent of the quota reflected not only an uncommonly strong program, but also an "uncommonly large balance-of-payments financing need", that would occur as a result of a radical reform being implemented. Such a high value of the stand-by credit increased Poland's credibility towards government creditors and improved their readiness to grant extraordinary assistance.

Not surprisingly then, the entire argumentation of the IMF representative, Peter Hole, presented on the forum of the Paris Club in February 1990, where the matter of granting a very generous and unprecedented rescheduling for 1990 to Poland was discussed, was based on the risk and uncertainty the reform implied and on the arising difficulties to estimate the impact of the reform on production and standards of living. Hole stressed two features of the Polish program that proved its uniqueness compared to other reforms, thus making its consequences unpredictable. He emphasized that the reform was based on a "clear break with the past" and that it was "uncommonly strong". Hence, the Polish government undertook "a course for which there are no obvious precedents" and no points of reference, which entailed grave and considerable risks.[232]

Hole indicated to the official creditors specific threats related to the uncertainty of the reform and the resulting larger financial needs of the economy. He listed three particular uncertainties as regards Poland's payment capacity.[233] The first concerned the extent to which exports could be held back by domestic supply disruptions. The second threat was related to the possible expansion of imports in response to a major liberalization of the exchange and trade system following the start of the reform. The third reason for uncertainty was that Polish enterprises were to be given the full responsibility for servicing new foreign loans.

In particular, the third uncertainty strongly highlighted the difference in the credibility of the old and the new Polish governments in the eyes of the IMF and creditors. Hole drew attention to the uncertain reaction of state enterprises that were on their own for the first time in

[232] IMF Archives, Country Files, February 1990, File 2. *Statement by Staff Representative to Paris Club on Poland February 14, 1990*.
[233] Ibid.

decades. This approach of the new government to enterprises should be compared to that of the former government on the very same matter. When in June 1989, the IMF mission demanded that conditions for financing state enterprises be tightened, the Minister of Finance attempted to discourage them from this idea, claiming that "credit and subsidy policies were established decades ago and cannot be simply eliminated 'in one go'."[234] This dispute pertained to the issue of a fundamental importance to the Fund, i.e. forming of equal financial conditions for all economic agents, conditions dictated by hard instead of soft budget constraints. It was this very willingness and consistency of the new authorities in making a clear break with the economic legacy of the past decades that best determined the difference with the former government, which opted for a gradual elimination. For the IMF, this was the key criterion for the willingness to build capitalism and, thus, credibility of the new government. Hence, Hole believed that the new government deserved exceptional financial support from the Paris Club countries.

Hole stated that each of these positions - exports, imports, capital inflows – was "subject to a much larger margin of error than usual."[235] What is more, this uncertainty of how the Polish economy would react to such a radical program gave rise to a tentative nature of the estimate of payments capacity. Hole stressed that the estimates that the Fund and the authorities made were decidedly more speculative than usual.[236] At the end of his speech, he called the official creditors to grant the Polish government their consent to debt service payments of less than the amount assumed in the program with the Fund[237] given such difficult conditions. As the main argument, he referred to the fact that the government's financial needs could not be estimated in the course of implementing such a unique and radical reform. Soon after, owing to an 'intervention' of Polish delegates, creditors agreed to a complete suspension of all payments (capital instalments, interests, interest on overdue interest) for the period of the stabilization program in 1990.

Poland would not receive such favorable conditions for the debt relief for 1990 if it were not for the grave risks involved in this very uncertain reform experiment. More importantly, having presented to the creditors all arguments for the special debt relief for 1990, Hole also stressed the need to give an "appropriate treatment of Poland's external debt over the medium term." Drawing attention to the fact that the reform was in its initial stage, Hole did not

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[234] IMF Archives, Country Files, Box 62, *Poland - 1989 Staff Visit*, Minutes of Meeting No. 16, June 8, 1989.
[235] IMF Archives, Correspondence and Memos, February 1990, File 2. *Statement by Staff Representative to Paris Club on Poland February 14, 1990*.
[236] Ibid.
[237] Ibid.

specify the forms of the medium-term debt treatment, claiming that it would only likely become clear in time. However, he stressed once again, it should take the form of exceptional financing.[238]

4) Creditors' argument: continuous financing gap as a key to debt reduction

In April 1990, in the headqarters of the Eximbank[239] in Washington a meeting was held with, among others, representatives of the Eximbank, CIA and State Department. The reason for the meeting was the need for discussing the most recent assessment on Poland's creditworthiness written by the Eximbank's economist Peter Gosnell. He emphasized the severity of Poland's current debt servicing burden and estimated that through the remainder of the decade, without the benefits of rescheduling, Poland's debt service ratio would be 84 percent "or higher than any other country on Eximbank's watchlist." He then added that "even continuous reschedulings did not bring prospects of <u>ever</u> [emphasis added by the author] recovering the ability to resume normal debt servicing on pre-1984 debt"[240] no matter the effectiveness of the reform being implemented. The reason was simple: in the 1990s, Poland was not expected to be capable of obtaining enough foreign currency to satisfy the needs for both imports and huge foreign debt. This in turn meant a "continually expanding financing gap through the whole decade."[241] The author stressed that this prognosis was based on the most optimistic assumptions.

Regardless of whether this important document known to IMF experts affected their strategy adopted in regard to the Polish debt, they were very well aware that a *continuous* financing gap necessitated the debt reduction. Their balance-of-payments projection of October 1989 foresaw a steady widening in the financing gap from nearly 3 billion dollars in 1991 to about 8 billion dollars in 1995, which was close to 80 percent of the total debt service due to all creditors in 1995.[242] As we can see, the Fund's estimation of Poland's financing needs was nearly as large as that of Eximbank.

The economic arguments pertaining to the radicalism and uncertainty of the reform were effective when the issue of payments due to the Paris Club was discussed in 1990. However,

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[238] Ibid.
[239] IMF Archives, Correspondence and Memos, April 1990, File 4. *Eximbank Meeting on Poland*, April 24, 1990.
[240] Ibid.
[241] Ibid.
[242] IMF Archives, Correspondence and Memos, November-December 1990, File 4. *Poland - Briefing Paper*, Manuel Guitian to the Managing Director, November 6, 1990.

as I have shown, Peter Hole used them also in February 1990 to justify the medium-term major restructuring of the Polish debt. Still, the financing gap in meeting Poland's debt payments for 1990, let alone increasing payments due after 1990, was similar in both scenarios – the phased and the rapid one. A small difference between financing gaps implied by both these scenarios was formed by smaller payment capacites of the monetary authorities resulting from a greater demand for foreign currency to supply the needs of imports in the case of a radical reform. It envisaged a radical opening of the Polish foreign trade, and the uncertainty related to the radical character of this action prevented the import needs from being precisley determined, and, thus, justified a greater financing of these needs by the West. Meanwhile, in 1990, it turned out that the import liberalization did not increase trade deficit. On the contrary. As a result of a huge trade surplus, reserves in the central bank increased. Consequently, there was no point for the IMF representatives to continue making references to inherent risks that went with a radical reform for obtaining the medium-term extraordinary debt relief.

It is worth noting that as creditors, Western governments had an economic interest to grant the debt reduction to Poland. It did not lie solely in a far perspective of a return to normal creditor-debtor relationships. The argument for the debt reduction was the existence of a huge financing gap which, as indicated in the Eximbank document, most probably would never be closed. The potential reduction of the Polish debt approved by the Paris Club (between 30 and 50 percent) was of a smaller scale than the one proposed by the IMF (about 50 percent), and definitely not of the scale stubbornly demanded by the Polish government (80 percent). The best known attempt at making a theoretical justification for foreign debt reduction from the view of the creditors' economic interest was the concept called the Laffer curve.

This concept stems from the idea of a debt overhang, which states that the market value of debt overlaps the nominal value of debt only until a certain moment. Further increase in debt makes payment perspectives decrease, i.e. the expected (market) value of debt falls and, as a result, an unrecoverable debt overhang is formed. The Laffer curve shows that from a certain point, debt can be only reduced if its market value is to be preserved - the value that is significant for creditors. Such an elimination of part of debt improves situation both for debtor and creditors. According to the only analysis made in 1991 by two economists on chances for receiving reduction by Central and Eastern European countries, only Poland qualified for obtaining large debt reduction[243].

In summary, the phased approach envisioned as in the August document (stagnation of the GDP instead of a fall in 1990 and balanced current account already in 1991) implied smaller financing needs. Nonetheless, they were insignificantly smaller than in the rapid approach. If we add the obvious interest of creditors in long-term payment capacity of Poland ensured by proper-scale reduction, it must be said that it was not the radical nature of the stabilization operation but the perspective of an enormous and continuous financing gap in the period after 1989 that constituted the main economic grounds for the debt reduction. The IMF and creditors knew that Poland was only one of many heavily-indebted countries applying for debt reduction. Internal analyses of the IMF devised in early 1991 with the intention to provide an economic justification for the Polish debt reduction proved that Poland's debt indicators did not give any more grounds for the reduction than those of other countries.[244] Below, I try to prove that the debt reduction was possible not that much due to a *radicalism* of the economic reform as to a *nature* of the Polish reform accentuated by the Polish government from the outset, i.e. the rapid transition toward a western-style economic system, and as to the interest of the International Monetary Fund to make the decision on debt reduction reality.

2. Political grounds for debt reduction

The very radicalism of the economic reform in the sense of its pace and scale of adjustment did not provide official creditors with a sufficient justification for granting the debt reduction to Poland. In 1989, Western governments even assumed that the reform had to be in lines with the support for the democratic revolution and expected it to be supported by means of generous rescheduling and new credits. This approach to debt relief had political grounds from the very beginning. After all, the debt reduction was eventually also granted due to political matters. In this case, it was not about providing financial support to the emerging fragile democracy in Poland but to support deep and comprehensive economic reform that was officially targeted at building a western-style economic system. When comparing the original criteria of Western governments, one has to say that the reform was even a threat to

[243] Dean, J., Simon, A., *Why Poland is a Special Case*.
[244] IMF Archives, Correspondence and Memos, March-April 1991, File 1. *Debt Reduction by Official Bilateral Creditors: Country Cases Poland and Egypt vs. Brazil, Hungary, and the Philippines*, March 4, 1991.

the democratization process. From the very beginning, both the government and the IMF representatives in Poland warned that the reform would surely decrease standard of living in Poland, which is always a threat to political stability. In order to help this peaceful revolt in taking a firm hold and to ensure future social support for the government, Western governments foresaw that the Polish reform would be given an exceptionally immense support.

Still, for Western governments, the most significant issue was the Poles' commitment to rapid transformation of their economy toward a western-style and market-based system. This was the main pillar of the political argument for debt reduction. This was Poland's perspective. While in the view of the IMF, the most important was a rapid success of the unprecedented reform in Poland that would have a positive echo in the entire Central and Eastern Europe. The common element of both these political arguments was stressing the uniqueness of the reform that consisted in the radical nature of means (shock stabilization) and the unprecedented objective, that is, system transformation. Only these two elements gave the effect of the unique reform of the rapid transition. What is more, one without the other would not give grounds for granting debt reduction. Only rapid transformation, as in the western model, served for the IMF and the Paris Club as the main criterion for further reduction, since the former valued rapid success of the reform, while the latter intended to use Poles to demonstrate to the world the determination and consistency in 'implanting' the West European economic order in Poland.

1) Commitment to building a western-style economic system

From the very beginning, Mazowiecki's government led an offensive on the international forum in which it emphasized the pro-Western direction of the economic reform (leaving its radical nature on the second place), which was intended to encourage Western governments to take active part in both financial and technical assistance. Although in practice, the terms 'stabilization-cum-structural reform' and 'rapid transition toward a western-style economic system' meant the same thing, it proved that the name of the reform had a fundamental importance. While the first term was of purely economic character and a tone that sometimes remained unclear for Western politicians, the second term drew attention and conveyed much more information in their eyes. This implied high determination of the Polish government, a direction of changes in Poland that was desired by the West and even a moral obligation to support such a reform.

The first document in which the government declared its intentions in the field of economy was the "Memorandum of the Economic Reform Program in Poland and the Role of Foreign Financial Assistance" written on September 23, 1989. This document was based on the "Memorandum" of September 14 written by advisers to the Polish government Jeffrey Sachs and David Lipton. Over a week, mainly with the involvement of Stanisław Gomułka[245], the text was given a necessary revision to emphasize the strategic objective of the reform, that is, to transform the economy in line with the West European model.[246]

This thread was present already in the first version of the text in the first paragraph: "the Government of Poland intends to transform the Polish economy into a market economy, with an ownership structure changing in the direction of that found in the advanced industrial countries."[247] In the new version, two sentences were added to stress the government's intention to build a system based on private ownership, modeled on West European states. A sentence from the original version, "the [privatization] process will extend over several years", was complemented with a sentence: "with the objective of achieving an ownership structure comparable to that of West European economies."[248] Then, the corrected text of the memorandum specified the objective of the planned privatization in Poland: "the basic design of privatization is likely to be along the lines carried out by some Western countries in recent years."[249] The word "some" allows to limit the range of West European countries to only a few, most probably Great Britain. This revision aimed at specifying what kind of economic system would the Polish government want to build, which was not insignificant given to whom the memorandum was addressed (ministers of finance of the Paris Club countries) and the title of the memorandum, involving "the role of foreign financial assistance".

[245] Stanisław Gomułka (1940 -), a Polish economist. In 1985, he became a consultant to the IMF on matters regarding Poland. He was one of the few to have a continuous influence on the shape of the reform between 1989-1994. In 1990-1991, he participated in negotiations with the Paris and London Clubs on the Polish debt reduction. At that time, he also was the main adviser to the Minister of Finance Leszek Balcerowicz and to his successors during the introduction of the IMF-supported program. In 2010-2013, together with Tadeusz Kowalik he published three volumes of the documents from the period 1989-1993 on various aspects of the Polish economic transformation, including Poland's cooperation with the IMF and negotiations on the reduction of foreign debt (*Stanislaw Gomulka and Polish transformation. Documents and analyses 1968-1989; 1990; 1991-1993. - three volumes*). Author of this thesis considers the conversations with professor Gomułka the most important among all the interviews he conducted with other participants in the Polish reform.

[246] *Conversation between T. Kowalik and S. Gomułka*. „Polish Transformation. Documents and analyses 1969-1989", p. 120.

[247] *Memorandum of the Economic Reform in Poland and the Role for Foreign Financial Assistance,* 14.09.1989*;* Polish Transformation, Documents and Analyses, 1968-1989, p. 496.

[248] *Memorandum of the Economic Reform in Poland and the Role for Foreign Financial Assistance (The final version),* September 23, 1989*;* Polish Transformation, Documents and Analyses, 1968-1989, p. 506.

[249] Ibid.

The other important element that was stressed in the official version of the memorandum (with due account of the Polish revised version) was additional emphasis put on the need for cooperation with Western governments in designing and implementing the reform in Poland. Both versions confirmed the willingness of the Polish government to work closely with the international community in the preparation and implementation of the economic reform program, and contained a declaration of Poland's economic integration with the European Communities through liberalization of foreign trade. In the second version, a paragraph was added where the Polish government called the EC states again to take active part in the implementation of the reform in Poland and declared willingness to accept various Western initiatives supporting investments, private sector and other areas.[250]

The official version is concluded with an assurance that the Polish government would like to work closely with other governments in defining the most important areas of assistance and in utilising this assistance in the most effective manner, which meant de facto inviting Western governments to co-create and co-implement the Polish reform. The key role of the Western financial assistance was strengthened in corrected paragraphs added to the Sachs's and Lipton's version. While in the first version there was only a note that foreign assistance "can provide the margin for success in the implementation of the reform program", the official version stated that "foreign assistance – both technical and financial – is necessary for the success of Poland's stabilization and reform program."[251]

In the second memorandum of the Polish government (prepared for the meeting of the Group of 24 in Brussels) devised three days later on September 26, also with the aim to gain external assistance for Poland, the government confirmed that it "is moving into a modern market economy which has passed its test in the developed countries."[252] It also made another declaration to establish close cooperation with the international community in preparing and implementing economic reforms. Lastly, the memorandum emphasizes the government's belief that foreign assistance was a fundamental condition of the successful and quick transition of Polish economy from a centrally-planned to a market-based system.[253] Thus, the government confirmed that it was aware of the fact that assistance was conditional on a determined implementation of the stringent economic program.

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[250] Ibid.
[251] Ibid, p. 507.
[252] IMF Archives, Poland, Correspondence and Memos, August-September 1989, *Memorandum Of Polish Government Concerning The Needs In External Assistance*, September 25, 1989.
[253] Ibid.

As a specific example of the technical assistance from Western countries, the Polish government gave an assistance in adjusting the Polish banking and tax systems to the norms in Western states. Nonetheless, assistance in implementing the institutional reform was of lesser importance than that in stabilizing the macroeconomic situation. One of the main co-authors of the Polish reform (both in theory and practice[254]) Stefan Kawalec admitted in an interview of 2011 that the assistance of the IMF was of key importance at the first stage of the reform, since Poland had no experience in effective inflation suppression[255]. In the initial period of Mazowiecki's government, when the fate of this highly hazardous reform undertaken by the Polish government depended on the scale of the assistance granted by the international community, the Polish government expected Western financial institutions to provide ongoing aid – both financial and advisory.

At the same time, the Brussels memorandum introduced a new matter of the geopolitical meaning of the success of the Polish reform. As if with the intention to justify the uniqueness of Poland's case compared to other states in need of assistance from the West, the Polish government drew attention of the EC countries to the historical meaning of the reform it undertook, claiming that "help for Polish reforms is not just an economic issue, as it will determine also the success of political changes which are of importance to Europe as a whole."[256] By stressing financial needs, the scale of the Polish reform and the historical value of this endeavor, it intended to attract the West to devising and implementing the reform and, thereby, taking some responsibility for it.

The government chose arguments to make the West feel obligated to provide exceptional help to Poland and not another country. To this end, free-market and a Western-style model of the reform that was being implemented was emphasized and, consequently, the key role of the West's financial and technical assistance in this project. Since the government wanted to conduct the reform in a way to become part of the West European economic system as soon as possible, the essential condition was to integrate in a short time and establish closer cooperation with the West than required in a gradual reform. Moreover, by stressing that the Polish reform would have implication for the entire Europe, the Polish government wanted to morally oblige the EC countries to provide assistance. Thus, the scale of assistance that was to be granted by the West was a test for the viability and attractiveness of capitalism as such.

[254] He acted as the Vice Minister of Finance in all four post-Solidarity governments in 1989-1993.
[255] Interview with Stefan Kawalec, Polish Transformation. Documents and Analyses 1990, p. 111.
[256] *Memorandum Of Polish Government Concerning The Needs...*

The ‘European’ dimension of the Polish reform was also accentuated by the vice president of the Central Bank Andrzej Olechowski in the already mentioned statement for the president of UNCTAD of early October 1989, where he claimed: “We are transforming from an authoritarian, centrally commanded country to a democracy and a market economy. This is an experiment nobody had attempted before. The most vital interest of our nation and the stability of Europe are at stake.”[257] Since the implication of the Polish reform to be experienced by the Western states were not only of economic nature, it deserved more than just an ordinary financial support. Olechowski justified this briefly: “We must not fail.”

Olechowski suggested that if there was an indebted country that deserved an exceptionally strong support from Western governments, it was Poland. Only Poland was “at a historical point”, as it was implementing an unprecedented and highly hazardous reform. Olechowski left no room for doubt regarding the determination and full commitment of the government to the radical reform, stating that “the need for the radical reform is both understood and recognized by the new government. There are no ways around it, [...] no shortcuts[258], [...] no alternatives to the full course of the reform.” Although it would be a painful task, the government would do it “fully, fast, unequivocally.”[259] To make the willingness to exclude any “third paths” more credible, Olechowski recalled that Poland made every effort to reform the centrally planned economy by various means, yet the system simply proved ineffective.

At the end, Olechowski proceeded to Poland’s specific expectations. First, he called the West to grant “access to fresh credits needed for specific, economically viable, export–oriented investment projects” to Poland. He then brought on the issue of the debt reduction, indicating that there was a threshold beyond which debt restructuring lost its meaning. Continuing restructuring resulted only in putting off the debt service burden and, thus, making it more difficult in servicing the debt once it was to be resumed.[260] Thus, by making a direct reference to Laffer curve, he indicated the very interest of official creditors to grant debt reduction to Poland. It seems that the two last arguments – the one about the adverse effect on creditors of extending rescheduling process and the one about the lack of alternative for building a market-based system – were best accepted by representatives of Western governments.

[257] IMF Archives, Poland, Correspondence and Memos, Box 62, October 1989, *Statement by Andrzej Olechowski at the 36 Session of UNCTA*, October 4, 1989.
[258] Particularly, the declaration to opt out of a shortcut said a lot in the case of Poland. This was the way chosen by the communist authorities in the 1970s, when instead of consistently reforming the economy they counted on a great modernization leap financed by Western loans. The result was Poland’s insolvency and the ‘lost decade’ of the 1980s.
[259] *Statement by Andrzej Olechowski...*
[260] Ibid.

A clear declaration on ruling out of alternative economic models was given by the Minister of Finance of the new democratic government Leszek Balcerowicz during his speech in *Sejm* in December 1989. Having stressed the willingness to build economy based on market mechanisms that would be open to the world and have an ownership structure that is present in highly developed countries, Balcerowicz justified the government's determination by saying [emphasis added by the author]: "For the first time in many years, the goals presented to the public are clear and pragmatic, not *invented* in nineteenth-century doctrines, but specific, *perceptible* beyond the Baltic or the Elbe [...] What, then, do we expect from this process to bring people? We want it to lead to a situation that is considered normal in developed countries of the world, and for us has been considered so far an unsurpassed ideal."[261] The message conveyed by Balcerowicz is that Poland had already conducted economic experiments, with poor effects. Thus, his government decided to build the model of economic system that had been historically verified. To put more clearly: the government did not want to go its own way, but to follow the path of West European free-market economies.

All political advantages of the reform were combined together in one document, namely, a letter of Prime Minister Mazowiecki to the Managing Director of the IMF and Western governments. The Polish Prime Minister spoke little about the details of the reform program, focusing instead (just as Olechowski did) on its political significance and indicated it as the justification for its uniqueness. He startsed with specifying that the aim of the government was to eliminate the hyperinflation and provide the foundations for a market economy based on the patterns of the developed nations. He then emphasized that the success of the Polish effort to sort out the economy and free it from the system under which it operated for 45 years[262] depended on the West. This confirmes that the argument about the decisive abandonment of socialism (more than about the restrictive nature of the economic reform) played the decisive role in appeals to the Paris Club. Mazowiecki also pointed to a political gain for Western governments in case the Polish reform succeeds, stating that "the success of our changes offer experience for the other countries of the region, perhaps including even the Soviet Union."[263]

What made this reform unique was the fact that it constituted an "unprecedented task in which much is unknown." This emphasis on risk inherently linked to the reform was used by the

[261] *Balcerowicz's Speech in Sejm*, December 17, 1989. In: Balcerowicz, L. *Wolność, równość, demokracja* [Freedom, Equality, Democracy], p. 18-35.
[262] IMF Archives, Poland, Correspondence and Memos, February 1990, File 2. *Letter from Prime Minister Mazowiecki*, February 9, 1990.
[263] Ibid.

Polish Prime Minister to make the West aware of the costs Polish society would have to pay, faced with "enormous austerity and a very hard test of patience" due to the reform. Therefore, to lead the operation to a successful conclusion, the government had to "concentrate all its resources".

Hence, the Prime Minister proceeded to the main objective of his initiative. He claimed that the resources owed by the government were insufficient to meet the objectives set by the government. Therefore, he turned to official creditors and the Fund for financial support that would ultimately come down to granting the debt reduction. At the same time, he ensured the Paris Club that the top criterion of Poland's financial reliability "is and will continue to be" to meet the past and future liabilities incurred by the current government. Having stated that an agreement with the Club was indispensable for confirming the reform planned for the 1990, he raised a "matter of extreme importance to the Polish government and one not easy to solve, namely, a long-term settlement of the Polish indebtedness, agreed upon with our creditors, leading to major reduction of the debt."[264] Only this could allow the country to become solvent in the long run.

At the end of the letter, Mazowiecki stressed an over-economic and over-political dimension of the financial assistance sought from the West by identifying the support for Poland in its efficient return to a free-market democracy with a challenge of a fundamental and historical meaning to West Europe, that is, "the rapprochement within the divided Europe."[265] By formulating possible consequences of a failure to grant financial support to Poland with such a pathos, the Polish Prime Minister intentionally morally obliged the West to active participation in the Polish unique reform.

2) IMF' s need for a spectacular reform in Poland

On September 19, 1989 a meeting was held in the headquarters of the IMF attended, apart from the Managing Director and several IMF experts, also by representatives of the World Bank, US Treasury and State Department. The topic of discussion was the Polish reform. The very fact that this meeting took place is an evidence that Poland was at the time a special case for the IMF and the US administration.

[264] Ibid.
[265] Ibid.

Only a week after Mazowiecki's government was appointed and before the government declared the economic program, the meeting participants were determining the key elements of the reform in Poland (all of which will become real). The program was estimated to take place over a 4-5 years' period, even considering the substantial frontloading of adjustment measures. Due to the magnitude of Poland's problems, two IMF programs were taken into account: firstly, the stand-by program, then a 3 years' long Extended Fund Facility (EFF). Lastly, they admitted that such a program should envisage resources for the debt reduction. Alan Whittome said that he expected a gesture on official debt relief, and Camdessus stressed this idea by adding that "in view of the unique political situation [peaceful replacement of communism for a free-market democracy], the Paris Club could show flexibility in the case of Poland without setting a precedent for other cases."[266]

Therefore, the Fund's Managing Director foresaw that Poland would be granted reduction due to political reasons. Elsewhere, while outlining the structure of the future reform in Poland, he stated that "there would no doubt be a financing gap but if the program was strong, the Fund could contribute substantially to its financing."[267] It is worth noting that Camdessus did not say that the strong program would form a significant financing gap and that was why the Fund would help finance it – this would be an economic argument for uncommonly strong financing. He said that there was a financing gap already in the starting point, and then made the Fund's assistance conditioned upon implementing strong program. Considering that at the meeting, "substantial financing" was understood as the debt reduction, the entire reasoning should be perceived as a political justification for debt reduction formulated by the Head of the Fund himself.

Camdessus clearly stressed this lack of alternative for the "strong program". Already at the beginning of the meeting he called the case of Poland "the most complex case faced by the Fund in a long time"[268] and strongly stated, "We must succeed and for this reason we need a program that is both strong and realistic." It is worth to stop here and reflect on this statement, trying to understand why it was so important for the Managing Director to implement the "strong program" in Poland. This sentence suggests that for some reason, the IMF needed a shock therapy, yet not due to the objective of rapid suppression of inflation, as this would be tautology. After all, as a rule, the IMF recommended other states to employ radical demand-

[266] IMF Archives, EURAI, Country Files, Poland, Box 62. *Poland - Meeting with Under Secretary of State for Economic Affairs McCormack*, September, 21 1989.
[267]Ibid.
[268] This sentence in the first copy from the meeting was crossed out and replaced with the following words in the official version of the document: "one of the most complex cases faced by the Fund in a long time".

restraint measures. Thus, the causal link indicated in the sentence "We must succeed and for this reason..." points to the fact that a radical anti-inflationary operation had some over-economic objective. Many documents I analyze below indicate that the IMF management counted on a spectacular reform in Poland to encourage also other countries of the region to undertake the radical path towards market economy. In order for the reform to succeed in Poland, debt reduction was necessary. Since the "strong program" in Poland was necessary due to political reasons, a debt reduction that would increase its chance for success was also of a political nature.

At a December meeting in Warsaw, the Managing Director in a conversation with General Jaruzelski indicated a broader meaning of the reform, claiming that the success of the Polish program was necessary not only for Poland, but also for other countries going through a peaceful evolution. Jaruzelski confirmed these words by stressing the significance of the consensus route accepted by Poland for the course of political processes in Central and Eastern Europe.[269] In response, Camdessus repeated that the history would recognize this peaceful evolution, and Poland's example would be a model for others. A month later, in a special film produced by the IMF addressing the Polish reform, Camdessus once again emphasized the aim of the "strong reform" in Poland, saying that although each country was a different case, other Eastern European countries were watching closely the Polish experiment to see if Poland's economic reforms could be the model for them as well.[270]

The hypothesis of the need for a spectacular success was also supported, although not in such a direct way, in a document containing an analysis of various sequences of actions in the reform. This was in fact a warning against the emerging consensus in the IMF regarding the demanded variant of the reform in Poland in the form of a priority of tight stabilization-cum-liberalization over the institutional reform. The document drew attention to threats related to this variant of the reform. Documents analyzed below prove that Polish authorities also had concerns regarding this variant, and even those representatives of the Fund who pushed it through themselves.

On September 13, on the day when the new democratic government was formed in Poland, Senior Economist of the IMF Thomas Wolf wrote to Peter Hole a memorandum entitled

[269]IMF Archives, Poland, Correspondence and Memos, February 1990, File 2, *A note about the discourse of President Wojciech Jaruzelski with the Managing Director in the International Monetary Fund Michel Camdessus (Belweder, December 11, 1989)*.
[270] IMF Archives, Poland, Correspondence and Memos, January 1990, File 3, *IMF film on Poland*, January 26, 1990.

„Poland - Some Thoughts on the Pace and Sequencing of Reform". The text concerned issues that were of fundamental importance for the reform, i.e. the sequence of liberalization, institutional changes and tight financial policies in the economic program. Wolf started with the theory. He emphasized that liberalization of prices and quantitative restrictions was the process that technically might be started and finished virtually overnight. It only required easing or eliminating formal quantitative restrictions.[271] Institutional changes, on the other hand, generally took longer.

Then, Wolf proceeded to the actual challenge to be faced at the time by the reforming centrally planned economies in Europe. These economies were deprived of free prices, permanent market institutions and market mechanisms that would regulate economic processes. Wolf made a proposal to apply the proper sequence of reforms in these countries, that is, in accordance with the model of a gradual approach in systemic transformation. He postulated either a simultaneous introduction of an institutional reform and liberalization (which would adapt to the inevitably slow pace of institutional changes) or to give precedence to a structural reform over liberalization.

Without a formerly set institutional 'infrastructure', liberalization alone could bring more harm than good. The faster the pace of liberalization, the greater the short-term pressures for a weakening of financial discipline and that could lead to an acceleration of inflationary pressures. This would indicate the need for putting into place the basic institutional 'infrastructure' before liberalization. By 'infrastructure', Wolf understood such necessary institutional arrangements as money and capital markets and efficient tax system. In the context of transforming regional economies, it is worth to add also autonomy of state enterprises and good conditions for new private firms. Due to inevitable social costs of the transformation reform, creating a well-developed social safety net was also necessary.

Lastly, Wolf stated that the current situation in Poland departed from this conventional picture in two respects. On the one hand, the specificity of the economic situation was determined by an already high and accelerating inflation. This required formulating, as soon as possible, a package of tight financial policies. On the other, Wolf drew attention to the fact that after 45 years, the new government in Poland had both "the determination and the ability quickly to push through necessary institutional changes." Thanks to this, "the required period of institution building and preparation for 'one go' liberalization may be significantly

[271] IMF Archives, EURAI, Country Files, Poland, Box 62, 1989. *Poland--Some Thoughts on the Pace and Sequencing of Reform*, September 13, 1989.

shortened."[272] In his opinion, the situation in Poland required from the IMF more than ever before to push through the key institutional changes in the first place, because the failure of the past operation of marketization of food prices[273] was caused by the lack of simultaneous demonopolization in this market.

In Wolf's analysis, the most interesting is his attempt to convince Hole that a rapid pace of the reform could be maintained also when opting for another sequence of actions than the one preferred by the IMF mission at the time. In his view, the determination and the reformist mindset of the new authorities in Poland would allow for a *swift* implementation of the institutional reform before the stabilization-cum-liberalization. Hence, Wolf suggested, the IMF mission would reach its goal, i.e. the *rapid* transformation in Poland.

Wolf's vision of the reform varied from that pushed through by the IMF missions in Poland in the first half of 1989. Already at the time, the priority was given to tight financial policies over liberalization and systemic reform. However, under the new political conditions that occurred in Poland in fall, the Fund was driven by two premises which made a radical reform that accentuated immediate adjustment program-cum-major liberalization and medium-term institutional reform prevail. First, the macroeconomic situation deteriorated drastically and objectively had to be immediately addressed. What is more, the catastrophic condition of the Polish economy made also the growing number of people in Poland, let alone the new reformist government, favoring the radical approach.

Secondly and more importantly, along with the progressing democratization in the region, the Fund needed a rapid success in Poland. The Fund could not base the reform on institutional changes, since they took long time by nature (new legislation, development of new procedures, training of individuals, etc.), such a reform would be less spectacular, and one would have to wait long for effects. Instead, the IMF wanted to take hold of a 'post-communist economic transformation market' and Poland was intended to be the model to be copied in the region. Already in August, representatives of the European Department drew attention to the proper timing for a radical reform, since Polish authorities were more and more convinced to the radical variant. Hence, the conclusion that "We need to take advantage of the momentum that is building in Poland (as in other parts of Eastern Europe) toward

[272] Ibid.

[273] The marketization of food economy was launched on August 1, 1989. The operation consisted in full liberalization of retail prices for food. Since it was not accompanied by tight financial policies (such as wage constraint) and demonopolization in the said sector, the 'marketization' of agriculture resulted in radical price hikes at an average monthly rate of 30 percent in the fourth quarter of 1989.

reform." In order not to miss this opportunity, one would have to mobilize international financial support for Poland. Otherwise, "an unsatisfactory attempt in Poland would be doubly unfortunate because of the externalities that can emerge from this country's efforts."[274]

Since Poland was of key significance for the IMF in its regional strategy, it had significant consequences for the shape of the reform in this country. In light of the above premises, Deputy Director of the European Department[275] Manuel Guitian was wondering whether the Fund should aim for anything less than a comprehensive reform and adjustment effort in Poland, for this was the only way to preserve the opportunity for assistance of the international community. After all, "second best reform options hardly live up to expectations."[276] A spectacular effect would not be ensured by an institutional reform that by nature took long, yet it could be obtained by combining major adjustment-cum-liberalization with the exceptional determination of the Polish government.

Moreover, in Poland's perspective, the option of tight financial policies backed by major liberalization was optimum. If Poland was to ultimately get out of the debt crisis, the debt reduction could be justified for creditors only by a rapid restoration of Poland's payment capacity, i.e. the rapid systemic change. In 1989, George Soros said that the debt reduction was impossible for West European countries did not believe that a fundamental market reform could be implemented in Poland.[277] Eventually, the Paris Club itself officially justified the debt reduction for Poland with the unique transformation reform. It is important since if Poland chose the gradual approach, it could not refer to the objective of the *rapid* building of capitalism in debt reduction negotiations. One can imagine, that a shift in the economic system takes many years or even decades, as in the case of Hungary, which started a market-oriented economic reform in 1968. In Poland, the unique thing was that the transition to a free market was to take several years. The shock therapy promised quick results that demonstrated the actual implementation of the above objective and thus made Polish government more credible in the eyes of the West. The positive effect on the official creditors of the track record in the last quarter of 1989 was a case in point.

Wolf warned against giving precedence to the adjustment-cum-liberalization especially in the context of centrally planned economies shifting towards the capitalist system. In his view, the

[274] IMF Archives, EURAI, Country Files, Poland, Box 62. *Poland - An Encore*, 23 August, 1989.
[275] The said Department led missions in Poland.
[276] Ibid.
[277] Soros, G. *Underwriting Democracy: Encouraging Free Enterpirse And Democratic Reform Among the Soviets and in Eastern Europe*; p.31.

lack of institutional ‘infrastructure’ in these countries gave very strong justification for the above sequence of actions. However, it was not the argument about the lack of capitalist institutions that was most important in the discussion on the pace of the reform, as the precedence of tight financial policies could be defended on clearly economic grounds. This was because giving precedence to institutional reform was a safer option in the light of historical uniqueness and, thus, unpredictability of the challenge of the economic transition as such. What is more, the IMF was well aware of that and still continued to force shock therapy through with a view of creating the spectacular effect.

When in December 1989, the content of the Letter of Intent was agreed on with the Polish authorities, a meeting of the management of the Fund was organized in the Managing Director’s office. The meeting was also attended by Jack Boorman, who was responsible for the considerable tightening of requirements for the track record in mid-1989, pursuing tight and comprehensive financial policies. Ten days before the beginning of the shock therapy planned by the Polish government to start on January 1, 1990, Boorman confirmed that it was, indeed, a tough program, and then admitted that he was concerned whether the program would bring results without any proper institutional ‘infrastructure’. Therefore, he called the Polish program “a leap of faith”.[278] This statement and the person who said it prove that the most important decision-makers in the IMF were fully aware that this program (the program that put emphasis on tight financial policies without an institutional reform) was very risky.

This belief must have been even stronger given that the Fund had no experience in conducting a systemic transformation. For this reason, the Polish reform was an experiment, and hence, by definition, its consequences were difficult to predict. This gave an opportunity to treat it on special conditions advantageous for Poland. The IMF representatives intended to rely on the unique character of the Polish reform in negotiations with Western governments on financial assistance for Poland. To this end, they were expected to stress two arguments. The first was an uncertainty argument, which referred to an inability to predict consequences of the reform, since no country ever changed its economic system in such a short time. The other one was an ignorance argument, which meant “our relative ignorance of the linkages and mechanics of adjustment in centrally planned economies.”[279]

[278] IMF Archives, EURAI, Country Files, Poland, Box 63, December 1989, *Meeting on Poland's Letter of Intent*, December 21, 1989.
[279] IMF Archives, EURAI, Country Files, Poland, Box 63, November 1989, *Guarantees for a Fund Operation with Poland,* November 30, 1989.

The uncertainty argument was objectively justified and, as I proved above, accepted by the Paris Club. In turn, the ignorance argument meant that the Fund intentionally ignored the specificity of centrally planned economies and pushed through its classic adjustment program, which by that time it had used to apply in countries which were more-or-less functioning within the market economy framework. Meanwhile, in the situation of such a great uncertainty of the reform in socialist economies, it would be safer to first focus on preparing the ‘infrastructure’ to increase the chances for implementing the stabilization-liberalization program. If one was to seek some historical points of reference, the accuracy of this sequence was indicated by the experience of Western developed countries when after World War II. Their economy was rebuilt relatively easily particularly due to the fact that these countries had a long experience of building capitalist economic institutions, part of which survived the war. However, the Polish reform was intended to deliver the rapid and spectacular effect, or even solely speed of proceedings. And this was to serve as the measure of success of this reform. Indeed, the Polish reform program was a “leap of faith”, yet on the very request of the IMF experts who co-created it.

3) Managing Director’s engagement for Poland

The very same concerns regarding the pace and the sequence of reforms were well-known to the highest authorities in Poland. Although the Ministry of Finance headed by Leszek Balcerowicz (and also, to a lesser extent, Władysław Baka, the head of the Central Bank) shared the Fund’s view, the latter “particularly stressed the need for any program to be one of the government as a whole - and not just of the Ministry of Finance.”[280] Meanwhile, in November there was still no consensus in the government regarding the right pace of adjustment despite the radical economic program publicly announced in early October. Solidarity leaders in *Sejm* like Bronisław Geremek or Witold Trzeciakowski feared that the shock action would not bring tangible improvements. Quite the contrary, they believed that an excessively fast pace of adjustment regarding prices, exchange rates and interest rates would lead many enterprises of key importance to the economy to bankruptcy. Consequently, a deep fall in production would take place, while employment would rise, and wages would go down.[281] Although the Fund mission admitted that this was true, at the same time it

[280] IMF Archives [...], *Poland*, M. Russo to the Managing Director, November 13, 1989.
[281] Ibid.

underscored the role of external financial assistance including social safety nets for the poor and unemployed “as a means of defusing such imponderables”.

Moreover, other leaders of ‘Solidarity’ from outside the government, such as the Chairman of Solidarity Lech Wałęsa, whose leadership Camdessus believed to be decisive[282], or the Senate Marshall Andrzej Stelmachowski in a December conversation with Camdessus stressed that adequate ‘infrastructure’ and foreign financial assistance should be the condition for the radical stabilization.[283] According to Wałęsa, the Fund and the government were moving too fast, as forming conditions for enterprises and presence of foreign capital in Poland was more important than suppressing inflation. Only when that was done, the money could be taken “from people's pockets”.

Camdessus gave them both the same reply: first a stabilization was needed, and then a structural reform, while financial support would come, since the West was willing to help Poland. On the other hand, this unprecedented goodwill of the foreign countries would not last long, so the government should proceed quickly and with no hesitation. As a reply to Wałęsa’s remark that Poland had to remain the pioneer of changes in the region, Camdessus noted that at the time, there was “a beauty contest: investors go where conditions are best”, and that conditions for foreign investment were where inflation went down. In other words, the government’s fast and decisive action determined its credibility in the eyes of Western creditors and investors.

Above, I referred to two conversations Camdessus held with the leaders of ‘Solidarity’ and General Jaruzelski. These took place in Warsaw, visited by Camdessus for several days to examine the mood of main social and political forces before ‘the zero hour’, i.e. the start of the reform. This very visit was something exceptional in itself and was a proof of the Managing Director’s high commitment to the Polish reform. This confirmed in practice his former declarations about the uniqueness of the Polish reform and the model-setting role of Poland for countries in the region. Another form of his personal commitment for the success of the Polish reform was calling Western governments to provide immediate financial assisstance to Poland. This pertained mainly to two initiatives: the speech in Brussels in December and the letter to the Paris Club countries of late January (the letter will be analyzed in the next chapter).

[282] IMF Archives, EURAI, Country Files, Poland, Box 64, *Summary paraphrase of meeting between the Managing Director and Mr. Walesa, Chairman of Solidarity*, December 9-10, 1989.
[283] Ibid.

In his Brussels appeal, Camdessus very strongly stressed the necessity for providing immediate financial support to Poland in its reform efforts. The scale and timing of that assistance had to be adequate to the needs of Poland, and not as governments would like to see it. When referring to the EC member states, Camdessus in fact stated that if their aid was ever very required, it was at that very moment. He said, “All too often in Fund-supported programs, we have seen adjustment efforts falter as a result of delays in providing assistance or because certain commodities may have been provided when cash assistance or different commodities had been expected. The tasks facing the Polish people and policymakers are already daunting; please let us not further complicate matters by being less than precise in our commitments or less than diligent in seeing them carried out.” This statement is an evidence of not only Camdessus’ personal or even emotional engagement in aiding the Polish government, but also of how reluctant European governments were to grant it, contrary to declarations.

This is evidenced by the case of arranging financial means for the one-billion-dollar Stabilization Fund. The essence of this mechanism, according to Camdessus, lay in its operativeness – the Fund was intended to be flexible and quick-reacting to ensure usability of the resources when the reform would take off on January 1, 1990. Meanwhile, in mid-December, Western governments were still reluctant to deliver proper amounts for the Stabilization Fund. Camdessus emphasized the “great urgency” of this issue and establishing the Fund on time.[284] Lastly, Camdessus concluded his appeal by calling governments to get ready to grant debt reduction to Poland in the future, which would be a decisive element for a positive assessment of the medium-term perspective of Poland.

The statement on debt reduction was added to a version of the appeal written for the Managing Director by Massimo Russo, which was confirmed by the former’s strong belief that reduction was necessary for the reform to succeed. It is worth to add that in the original version of the appeal, there was no emotional tone, which was very clear in the final version. The fragments added to Russo’s version had a common feature, namely, they were an emotional emphasis on the urgency of the West’s external assistance for Poland. The fact that Camdessus rejected the first version of the appeal gives an evidence of his special care to ensure the adequate financial assistance for Poland.[285]

[284] IMF Archives, EURAI, Country Files, Poland, Box 63, *Remarks by the Managing Director before the meeting of G-24 ministers*, Brussels, December 13, 1989.
[285] Ibid.

3. IMF's argument for debt reduction: need for additional safeguard

Above, I made an attempt to show that the IMF needed a strong reform in Poland because it wanted to have a quick success in the region that would increase the prestige of this institution in the eyes of other countries undergoing transformation and ensure closer cooperation. In order for the Polish reform to be successful, the Fund was ready to negotiate debt reduction for Poland. Importantly, the uncertainty of the reform that was rapid, broad and extensive translated into uncertainty whether the resources invested by the Fund in that reform would be paid back. This also required special treatment of the Polish reform on the part of the Fund, including Camdessus himself. For this reason, as the main argument for a significant debt reduction, the IMF representatives stressed on the international forum that it was the only guarantee for safety of its resources in the mid- and long-term.

This line of reasoning constituted the third type of justification for reducing Poland's debt that is analyzed in this chapter. The Fund's stance on this matter was eventually expressed in a letter from the Managing Director to the Paris Club countries of January 1990. Before I proceed to the letter, I would like to present how that stance was developed in the internal discussion between the Departments in the IMF. Hence, I will show how Western official creditors and the Fund eventually shared responsibility for the fate of the Polish reform and what role debt reduction played in it.

1) How to secure Fund resources in Poland?

Debt reduction was embedded in the success of Poland's radical reform from the very beginning. Poland assumed that debt reduction would be necessary for the reform to be successful, which was visible in its international offensive directed to official creditors at the turn of 1990. I would like to show that also in the perspective of the IMF, long-term unprecedented debt relief seemed a necessity, as only such a relief ensured return of the resources the Fund would entrust to the Polish government. On first sight, there was nothing specific about it. The IMF always required financing assurances before signing an agreement with a member state. These safeguards, aside from ensuring orderly relations between the member country and its creditors, were also intended to help return the country to a viable balance-of-payments position, enabling it to repay the Fund.[286] On the other hand, due to the vast continuous financing gap combined with Poland's exceptionally low payment capacity, even when one assumed that the reform would be implemented in a consistent manner, the issue of debt reduction in the case of Poland was particularly strongly accentuated by the IMF in contacts with Western governments.

In his letter to the Paris Club countries from January, Camdessus justified the exceptional nature of Poland's case saying that assurance of security of the IMF funds was not provided by the factors that were usually sufficient, i.e. commitment of the Polish authorities to a strong reform, and the reform itself.[287] On the contrary, the reform gave rise to such a great uncertainty as how economy would react that Poland's external viability was threatened not only in 1990 but also in mid- and long term. Therefore, Camdessus stressed that in the case of Poland, "more will be needed". Hence, the IMF demanded from Western governments an exceptional financial safeguard as part of mid-term safeguards and exceptional financing in the form of rescheduling in 1990.

The fact that even strong adjustment policies sustained over the appropriate period were not enough in the case of Poland proves that the factor that made Poland insolvent in the long term was primarily the financing gap. Therefore, the Fund experts' accentuating in official speeches the inherent uncertainty and risks that came with the radical Polish reform was more of an evasion. One could not base his line of reasoning on the existence of an enormous and persistent financing gap, since Poland was only one of many heavy debtors in the world, and each of them had similar claims. Nonetheless, what made Poland's reform stand out and gave potentially strong grounds for debt reduction was its historical uniqueness: a large scale of unpredictability of the rapid transition in Poland meant risks of losing the Fund financial resources in Poland. This was the key argument for the long-term major debt restructuring used by the IMF in negotiations with the Paris Club. What is equally important, the Fund was driven in this case primarily by its own interest, i.e. the need to maintain ongoing liquidity of its funds as the main international creditor institution. However, the fact that the 'uncertainty argument' was an evasion and not an objective necessity is evidenced by the fact that it was not used by the IMF delegates later in 1990, as the risk of the Fund being not paid significantly decreased due to a considerable foreign exchange reserve accumulation over the

[286] IMF Archives, Poland, Correspondence and Memos, February 1990, File 1, *Letter of the Managing Director to Major Creditors*, January 30, 1990.
[287] Ibid.

year. Meanwhile, the issue of long-term insolvency in the form of the enormous financing gap that overshadowed the reform remained unsolved.

The major criterion for the IMF in determining the required scale of financial assistance was the perspective of a debtor's balance-of-payments. The Fund's attitude towards a member's request for financial assistance was normally closely tied to the staff's judgment about the member's ability to resolve its balance-of-payments problems in a relatively short time, so that a debtor could pay the credit within the maturity date. In line with the above, the guidelines on access cautioned against committing Fund resources in the absence of medium-term balance-of-payments viability.[288] The point is that in Poland of 1989 there was no perspective for mid-term external viability, hence, there was no prospect of the Fund's resources being repaid. The Fund had to solve the problem before the stand-by agreement was concluded with Poland.

2) In search of the up-front debt reduction

Initially, the IMF intended to obtain additional financial safeguard from Western creditors for its resources in the form of general assurances for the Polish debt reduction. These attempts failed due to strong reluctance of both groups of creditors to taking such a step, especially *before* the conclusion of the SBA with Poland. Hence, the reform was about to begin soon, and the IMF still had no additional safeguard for its resources.

In this situation, Mark Allen outlined an alternative the Fund faced in October 1989: "From the Fund's perspective, should we withhold support [for the SBA] until there is an agreement on a reduction of external debt (official and private) to levels that enable a return to a viable balance-of-payments position within the medium term? Or should we go ahead and deal with the short-term problems, including an adoption of the most essential structural reforms, leaving debt restructuring to take place 2-3 years down the road?".[289] This question had a significant impact on the shaping of the future debt strategy. The Fund had to choose between withholding the SBA until obtaining debt reduction safeguards from creditors or sacrificing mid-term outright safeguards for the Fund's resources to proceed to the implementation of the reform as soon as possible, and, in line with the above, expect at that time only short-term safeguards. Allen supported the latter option by referring to the unique and transient climate

[288] IMF Archives, EURAI, Country Files, Poland, Box 63, *Guarantees to Fund Operations*, J. Pujol to L.A. Whittome, November 27, 1989.
[289] IMF Archives, ETRIC, Country Debt Files, Box 7 Poland – Debt File 1983-1991, Allen Mark: *Poland-Financing Strategies*, *Debt Reduction and the Commercial Banks*, October 3, 1989.

advantageous to the radical reform in Poland. The political resolve in Poland and the emergency financial support from abroad could evaporate if the Fund waited for the mid-term external viability guarantee. This situation gives a good picture of the correlation between the radical nature of the reform and the specific, very short period in which such a reform could have been launched.[290] Ultimately, the second option proved the right decision made by the Fund, as the (conditional) consent of the Paris Club for debt reduction was not obtained until 1991. Western governments were most afraid of granting Poland a one-time and, hence, irreversible reduction described in the mentioned document by Mark Allen.

The righteousness of the above-described Allen's hunch was provided in Russo's memo from mid-November, in which he stated that the financial gap had to be closed as soon as possible if the program was to be launched according to plan, that is, on January 1, 1990. Otherwise, the support it would have received in Poland and abroad could quickly evaporate. Neither banks nor the Paris Club saw any chance of agreeing on the matter of debt reduction at that time. Hence, there was nothing else to do but to tackle the debt service issue on 'ad hoc' basis by postponing it and focusing on obtaining the reduction when the reform program was being implemented. The Fund also intended to inform creditors of the necessity to ease the debt service burden after 1990. The Polish authorities approved and claimed that they would not seek a reduction in debt or in debt service obligations in 1990, but they intended to initiate such discussions not later than in 1991.[291] They accepted that it would be desirable to aim to return the convertible current account to balance in 1993 when repurchases from the Fund would begin to fall due, yet on the condition that the debt burden to both groups of creditors be alleviated.

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It should be stressed that the Fund tried to ensure financing assurances even before the launch of the reform for its entire duration (4-5 years). With the attempt to obtain safeguards for the Polish debt reduction, from the very beginning, the IMF stressed the feeling of uncertainty regarding the course and outcomes of the reform, so that it had a safeguard for its resources to be returned. Below, I present an internal IMF discussion that made the Fund abandon this 'egoistic' stance and ultimately agree to a more balanced distribution of responsibility with

[290] For Leszek Balcerowicz, the date January 1, 1990 as the launching day of the reform was a deadline that could not be expired. At the end of December 1989, in fear of the date being postponed, Balcerowicz threatened the Prime Minister with resignation. Also the IMF missions repeatedly stressed the necessity to meet the deadline.
[291] IMF Archives, EURAI, Country Files, Poland, Box 63, *Poland,* M. Russo to the Managing Director, November 12, 1989.

the Paris Club regarding the strategy towards Poland. As a result, both parties agreed to ensure suspension of the debt service for Poland for the period of the stand-by program in 1990, without specifying the term and the form in which mid-term safeguards would be obtained.

Hence, the Fund came to terms with remaining uncertain of the ultimate success of the Polish reform. This had very significant implications for the further implementation of the reform program. It meant that the Fund, which wanted to complete the reform, had to ensure mid-term assurances for it, yet this was possible only as part of the subsequent program (another SBA or an Extended Fund Facility - EFF). In turn, "specific modalities of the needed approach to debt" in the mid-term was to be determined by the Polish authorities' capacity to implement the first SBA program of 1990 which was to terminate in March 1991. This capacity was indicated by the extent to which 'performance criteria' specified by the IMF were met. Since the Fund had to continue its attempts at debt reduction being granted to Poland, chances for it increased considerably, yet only on condition that the adjustment program be implemented in 1990. This was the only way for Poland to prove that it fully took advantage of the unprecedented debt rescheduling granted in 1990 by the Paris Club in agreement with the IMF.

3) Need for a collateral

The fact that debt reduction could not be obtained before the agreement with Poland on the stand-by credit left the IMF in a very fragile situation, as it meant that it had no financing assurances and the reform was soon to begin. Initially, debt reduction was to serve as financing assurance, yet it proved unobtainable. Thus, eventually, Poland was granted an exceptionally generous debt service rescheduling for the period of the stand-by program in 1990. Nonetheless, the Fund still wanted to obtain a safeguard of some sort for its resources that were to be engaged in the Polish reform planned for a 5-year period.

In order to solve the problem of gaining up-front mid-term assurances by the Fund, a discussion was initiated in November between the IMF departments on the need for both immediate and mid-term additional assurance. The discussion was sparked by the fact that creditors refused to give their initial consent to debt reduction, while ensuring mid-term balance-of-payments viability was still a necessary condition for the reform to succeed and was possible only if the burden of debt to both official and private creditors was lightened.

One of the participants in the said discussion stated what should be done in the case of delay in completing negotiations on debt and debt service reduction or long-term restructuring of the external debt - in such a case, additional safeguards should be obtained.[292]

Who should grant them and in what form? An answer to the first part of this question was provided by one of the Fund's experts involved in the internal discussion: "In cases where it is questionable whether a sustainable position not requiring exceptional financing could be achieved over the medium term, the Executive Board has recommended that the Fund's role be primarily catalytic, with the great bulk of the external financing provided on appropriate terms from sources other than the Fund."[293] In the case of Poland, this meant that additional mid-term guarantee could be granted only by Western governments.

The same author justified the need for additional guarantee with the fact that while the Fund was being asked up front for a large access to its resources by the Polish authorities, "great uncertainties prevail concerning the possibilities and timing of the achievement of balance-of-payments viability." The IMF could then decide not to engage in a financial arrangement with Poland if the creditors were not prepared to provide the financing of both immediate and future gaps in balance-of-payment needs.

Importantly, this line of reasoning pertains to the need for gaining safeguards by the IMF for its resources. The Fund's expert does not mention that Poland was going through a fundamental economic transformation and for that reason deserved exceptional financial assistance. It was the Fund and not the Polish government who sought "assurances from Poland's major creditors that the Fund will be repaid on schedule". The author of this assertive proposal de facto foresaw the Fund would resort to coercive measures with regard to creditors. This would mean that Western governments would not only be under pressure of Poland that would implement the transformation reform as modeled on the West, but also under the pressure of the IMF, which could not become permanently engaged in cooperation with Poland before gaining mid-term financing assurances from creditors. Without this support, it could not give a guarantee for the reform due to grave economic risks it entailed.

As for the key question on how to obtain payment assurance to fulfill *future* gaps together with *immediate* gaps, the author of the document came up with an idea of demanding "some form of collateral". This would be an "advance commitment" in the form of "written

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[292] IMF Archives, EURAI, Country Files, Poland, Box 63, *Guarantees to Fund Operations*, J. Pujol to L.A. Whittome. November 27, 1989.
[293] Ibid.

assurances" from major creditors "to the effect that they were prepared to extend debt relief or new credits, as needed."[294] A few modalities for collateral were discussed as mechanisms to secure repurchase obligations to the IMF: pledging of gold; establishment of special reserve accounts in the Stabilization Fund to meet the eventuality of nonpayment; issuing of special zero-coupon bonds; commitments for assistance from creditor countries in amounts sufficient to ensure eventual settlement of repurchase obligations.[295]

The last of the listed forms of collateral (in the form of extending debt relief or new credits) was expected by the Fund as guarantees for its resources from the Paris Club in 1987 before signing an agreement with Egypt.[296] However, Western governments refused to give such written assurances as they did not want to take on a "burden of what is considered to be 'ex ante' a doubtful loan, even before the operation is concluded"[297] Hence, creditors did not want to offer any guarantee for the reform program, since they had no guarantee themselves it would be successful.

As can be seen, the Paris Club refused to grant an advance mid-term guarantee due to the very same reason the IMF used as grounds for demanding this from it in the case of Poland, that is, excessive risk of resources not being returned. Still, there was a more significant meaning to the Club's refusal. Creditors did not want to give written assurances of mid-term debt relief, as they were concerned that such mechanism could set undesirable precedent for other debtors who could ask for a similar treatment, and that would mean "a proliferation of doubtful loans".[298] Even a more grave consequence was moral hazard, which would mean a lack of debtor's expected motivation to implement a strong adjustment once he received an assurance. This very requirement of a one-time and permanent safeguard granted for the duration of the reform program, even before an agreement on the program was concluded, made creditors most reluctant to give reduction guarantee. As I show below, the Paris Club eventually granted partial reduction to Poland only when a considerable part of the unprecedented transformation reform planned for 4-5 years was already implemented, with the second tranche of debt reduction being conditioned on whether the reform was continued in cooperation with the IMF. This was the only way for the Club to avoid the risk of precedent and moral hazard.

[294] Ibid.
[295] Ibid.
[296] Ibid.
[297] Ibid.
[298] Ibid.

Therefore, the Fund had to abandon the willingness to obtain upfront mid-term assurances for its resources. This was due to internal criticism toward the above proposal of gaining mid-term collateral before the launch of the reform. These critics used several arguments. Firstly, an attempt to blackmail creditors could be counterproductive: since the IMF cared solely about guarantees of its own due payments, it thus showed that it saw the entire reform program as too risky.[299] How could it thus demand that Western creditors financed such a program? This would raise fundamental questions about the role of the Fund in providing a 'seal of approval' of its members' policies.[300] By officially making the launch of the reform conditional on obtaining advance guarantees for its resources, the Fund put its own credibility into question. Secondly, by publicly demanding an explicit guarantee of its resources in the form of collateral, the Fund showed it wanted to get rid of the responsibility for the 'exceptionally uncertain' program in Poland and put it all on the Paris Club, which the latter would definitely not accept.

Another voice in the discussion on possible guarantees for a Fund operation with Poland put forward a solution to the problem that required neither collateral nor an advance guarantee. The author stated that in a situation where collateral was not possible, creditors could reschedule their claims on the debtor, so that the member's repurchase obligation to the Fund be discharged within the prescribed period. This action, called in the document "a reduction of the financing gap", made it possible to extend the assistance of the Fund while safeguarding its resources.[301] Here, he did not speak about debt reduction but about major rescheduling and reduction of financing gap as guarantees of mid-term balance-of-payments viability that would ensure repayment of resources to the Fund. Moreover, even this guarantee was uncertain to be obtained due to the mentioned concerns of the Paris Club. However, as the author put it, "we have no choice but to share the risk with other creditors."[302]

This leads to an important conclusion: debt reduction was not a necessary condition for the repayment of the Fund's resources engaged in the Polish reform. Regardless of the economic arguments for debt reduction - "grave risks" and the response of the economy - the prospect of the IMF resources being repaid required no reduction. An adequately generous rescheduling would suffice for the Fund to have ensured financial security in a long-term

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[299] IMF Archives, EURAI, Country Files, Poland, Box 63, *Guarantees for a Fund Operation with Poland,* Leo Van Houtven to L.A.Whittome. November 30, 1989.
[300] IMF Archives [...], *Guarantees to Fund Operations*, J. Pujol to L.A. Whittome. November 27, 1989.
[301] IMF Archives, EURAI, Country Files, Poland, Box 63, *Possible Guarantees for a Fund Operation with Poland,* F. Gianviti to L.A.Whittome. November 29, 1989.
[302] IMF Archives [...], *Possible Guarantees for a Fund Operation with Poland*, B. Aghevli to LAWhittome, November 29, 1989.

cooperation with Poland. The document also stated that the only direct guarantee for alleviating the financial risk involved in the reform for the Fund was to press for as strong a program with as limited Fund resources as feasible.[303]

4) Managing Director's letter to the Paris Club

Therefore, the IMF was aware that it would not get from the Paris Club a financial collateral before the program is concluded. However, it was statutorily obliged to have such a guarantee for the duration of the economic program, since without it, the Executive Board would not approve it. Thus, in a letter to official creditors sent on January 30, 1990, the Managing Director stressed that strong adjustment policies, sustained over the appropriate period, provide the best assurances not only for the IMF but for all creditors.[304] It recalled, then, that the variant of the reform chosen in Poland was a response to creditors' expectations.

Camdessus also ensured the Club that even though the program was very hazardous, he said he was „optimistc for its success" as far as the program was fully supported by the international community and a deft implementation by the government. Ultimately then, the Fund did not question the chances for implementing the Polish program in public, nor did it demand the Club to give explicit mid-term guarantees, and that proves it abandoned the claims against creditors it initially considered. However, Camdessus made it very clear that his optimism regarding the implementation of the reform depended on an exceptionally large financial assistance from Western governments for the entire duration of the reform.

In turn, for the year 1990, the IMF demanded only short-term guarantees in the form of exceptional financing. Thus, it chose not to seek to obtain mid-term guarantees in advance for its resources. Nonetheless, it emphasizes that the Poland's balance-of-payments had poor prospects and that determination and the strongest efforts of the authorities were not enough. This is the grounds on which the IMF based its line of reasoning for the Paris Club that Poland was a special case and that "more will be needed". He stressed the need for an appropriate treatment of Poland's external debt over the medium term, yet specified neither the form nor the term when they should be received. Although he did not use the word 'reduction', he left no doubts that there was a necessity of a major debt restructuring as the

[303] Looking at it from a different perspective, the fact that the IMF maintained 80 percent of the quota for Poland without having the unprecedented guarantee for repayment of their resources proves how much the Polish program meant to it.

[304] IMF Archives, Poland, Correspondence and Memos, February 1990, File 1, *Letter of the Managing Director to Major Creditors*, January 30, 1990.

minimum condition for allowing Poland to be put on a less vulnerable and more sustained medium-term adjustment path."[305]

The meaning of "major restructuring" for the IMF is evidenced in the above-mentioned documents where it considered only debt reduction as the condition for the ultimate success of the reform. Here, it is worth to recall another document, from late November 1989, in which the IMF assumed the need for debt reduction in medium term, claiming that "our medium-term external scenarios suggest that in the absence of debt and debt service reduction (from both official and private creditors), Poland is unlikely to attain balance on its current account before 1997 or perhaps even later. In the meantime, debt would continue to accumulate and external viability ratios would remain very adverse."[306] The Fund chose to abandon medium-term guarantees before the launch of the reform, although it knew that if it failed to obtain them later on, the reform would fail as well.

This aspect is vivid in Camdessus' letter that was written primarily with the prospect in mind of obtaining guarantees for the IMF resources. The letter contained an element of blackmail against the Club in that the Fund made long-term support for the reform conditioned on exceptional financial support being granted by the governments. At the end of the letter, Camdessus informed creditors that he wanted to present the special needs of the Polish case to ensure that all requirements would be met to justify Fund financial support for the Polish program.[307] Without these special needs of the Polish case being met, the reform could not be continued in the form of EFF or another SBA. In the context of the need for a long-term safeguard of the IMF resources one has to see the IMF ultimatum against the Paris Club from early 1991 when it informed the latter that without debt reduction, the reform in the form of EFF could not be continued. Hence, it was an exceptionally strongly grounded request of the Head of the IMF to official creditors and an exceptionally strong support on his part for the Polish program.

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As a matter of fact, the entire internal discussion in the Fund depicted above revolved around the following issue: should additional guarantees (in any form) be granted before the agreement is concluded (so that the IMF was ensured that it would get its resources back), or

[305] Ibid.
[306] IMF Archives, EURAI, Country Files, Poland, Box 63, *Poland*, M. Russo to the Managing Director, November 27, 1989.
[307] IMF Archives, Poland, Correspondence and Memos, February 1990, File 1, *Letter of the Managing Director to Major Creditors*, January 30, 1990.

should the IMF and the Paris Club take on joint responsibility for the reform deprived of mid-term guarantees and, hence, highly uncertain? In the second scenario, the IMF would have to abandon seeking advance mid-term assurances from the Paris Club, and the latter would make such guarantees conditioned on the determination and effectiveness of the Polish government in implementing the stabilization program.

The Fund foresaw that the Paris Club would not grant outright mid-term guarantee before an agreement was concluded between the IMF and Poland, as it was concerned of setting precedent in this situation. This would also entail the problem of moral hazard, that is, a debtor's temptation not to implement the reform in the way it would if debt reduction was conditioned on the reform being implemented. A consistently implemented radical reform would decrease moral hazard, since the Paris Club would not consider the granted guarantees an "ex ante doubtful loan". What is more, stabilization of the macroeconomic situation, in line with the IMF program, would also prove for the official creditors that the Polish authorities appreciated the exceptionally generous rescheduling granted to Poland for the period of stabilization. For the Paris Club, Poland was credible as long as it implemented the stabilization program.

It should be emphasized that although the guidelines on access to Fund resources cautioned against committing these resources in the absence of medium-term balance-of-payments viability[308], and this perspective was not obtained, a decision was made to conclude a program with Poland anyway. This meant that the Fund took responsibility for the Polish program and that from then on, it would function (as the Paris Club did) in uncertainty of its success and security of its own resources. More importantly, the Polish reform would have a greater chance for success than other programs, since the IMF had a political interest in making the reform succeed. Debt reduction was to serve this political aim and not the Fund to regain its resources.

Here, I would like to get back to the starting point of this part of the chapter where it was mentioned that the line of reasoning used by the IMF regarding the need for an additional safeguard for its resources was a mere evasion. In this way, the Fund wanted to somehow circumvent the problem of continuous financing gap, which was universal in the debtors' reality. However, justifying reduction or long-term major debt restructuring to the Paris Club by a huge financial gap would be pointless. The fact that the issue of the additional safeguard

[308] IMF Archives, EURAI, Country Files, Poland, Box 63, *Guarantees to Fund Operations*, J. Pujol to L.A. Whittome. November 27, 1989.

was not the major argument used by the IMF for future reduction is evidenced by the fact that in the January staff report, the IMF mission indirectly admitted that debt reduction was not necessary as an additional mid-term safeguard for its resources, although at the very same time the Fund officially claimed otherwise. Camdessus in his letter to official creditors wrote about the unusually bold and wide-ranging program of economic reform that was, however, not without grave risks. And that gave rise to uncertainty whether the resources engaged by the IMF in Poland would be regained and for that very reason, as Camdessus argued, both immediate and long-term exceptional financing was necessary. As mentioned earlier, in his Brussels appeal to governments of the European Community, Camdessus explicitly stated that granting mid-term debt reduction to Poland would be necessary.

In the January Staff Report, the baseline scenario was discussed, which as the only one of four scenarios assumed continual strong adjustment supported by conventional financing (debt rescheduling plus new credits), and not debt reduction. In line with this scenario, the Fund's exposure in Poland would amount to a small proportion of Poland's total debt and repurchase and charges would absorb no more than 2.5 percent of export receipts in 1993.[309] This meant that the Polish government would be solvent to the Fund when it started repaying IMF credits under the agreement concluded in February 1990.

In sum, the IMF did not have to seek reduction of Poland’s debt from creditors arguing that only in that case (i.e. in the ‘reduction’ scenario) it could undertake a long-term and very difficult reform in Poland. The Fund knew that it would be repaid also in the scenario that envisaged conventional financing. Nonetheless, it continued to argue for the reduction, as it wanted the Polish reform to succeed due to political reasons. In turn, it justified this for the Paris Club by claiming that without debt reduction there would be no mid-term external viability. That was true, and the IMF indeed assumed that the baseline scenario would still leave Poland with a current account deficit in 1995 at about the same level as in 1989[310]. However, it was not true that debt reduction was necessary for Poland to repay the IMF resources and the Fund knew it well. If reduction of the Polish debt was considered in the West, it was always as possible support for a unique and historical reform and not for an economic benefit such a reform would bring.

[309] IMF Archives, Poland, Correspondence and Memos, January 1990, File 2. *Staff Report for the 1989 Article IV Consultation and Request for Stand-By Arrangement: 3. Balance of payments in the medium-term.*
[310] Ibid.

Chapter IV. Debt reduction held in abeyance

In the last chapter of the first part of the thesis, I describe which of the above-presented criteria for debt reduction played the key role in 1990. I make an attempt to prove that it was the argument about the unique transformation reform (rapid transition to a free market system) that influenced creditors to a greater extent than economic arguments did or those referring to the need for an additional safeguard for the IMF resources. More importantly, the economic situation that formed at the end of 1990 put the very essence of all the three types of arguments for reduction into question.

Firstly, the radical nature and unpredictability of the reform did not translate into a need for immediate and exceptionally large financial assistance from the West. This resulted from emergence of surprisingly big budget and trade surpluses in the middle of the year. As Stanisław Gomułka put it in 2011, "In 1990 we were also highly surprised *in plus*: a considerable departure of the program was the occurrence of a serious surplus of export over import. This alleviated the negative effect of a large decrease of economic activity and employment. As a result, national income and industrial production in Poland were the lowest (aside from Slovenia) of the countries which were undergoing transformation."[311] Meanwhile - as I tried to show - it was the very radical nature of the reform and the resulting deep fall in GDP that were indicated as the justification for debt reduction.

Secondly, in the middle of the year, the government made a correction in the macroeconomic policy in the form of easing of the fiscal and the monetary policies. This deviation from the agreements made with the IMF were justified by the willingness to stop a fall in the GDP. The change in the macroeconomic policy was reluctantly accepted by the IMF, which earlier strongly warned the government against the adverse effects of policy relaxation. For the need of the Fund's negotiations with Poland, a report was drawn up, showing the recent experiences in Argentina, Brazil, and Yugoslavia, where premature relaxation did not bring about significant improvements in production but quickly revived inflation.[312] The Fund

[311] Conversation between T. Kowalik and S. Gomułka. „Polish transformation.Documents and analyses, 1990", p. 38.

[312] IMF Archives, Poland, Correspondence and Memos, March 1990, File 3: *Yugoslavia: Some Lessons from Experience in 1988 with Anti-Inflation Program* ; facsimile from M. Russo to P. Hole describing the Latin American (Argentina, Brazil) experience with inflation stabilization in 1989, March 23, 1990.

believed that “the Polish experiment is too important for allowing it to fail in this way”[313] and discouraged the use of both surpluses to increase economic activity. Soon, the correction of macroeconomic policy turned out to be excessive. The credibility of the Polish government was seriously compromised due to the deviation from consistent implementation of the rapid transition reform agreed on with the IMF at the end of 1989.

Thirdly, the excellent condition of trade balance and budget balance in the first half of 1990 questioned the ‘uncertainty argument’ used by the Fund to gain extra guarantees for its resources involved in Poland. From then on, this argument was no longer used in official negotiations with the Paris Club.

Therefore, the economic reform brought unanticipated positive outcomes, although they aggravated the prospect of debt reduction. In the next chapter, I attempt to prove that the only solution to this situation was for the government to confirm its commitment to the rapid transition into capitalist system. This was to oblige Western governments to support financially the reform, which intended to build ‘their’ economic system in Poland in short time. Still, also for the IMF, this unique reform had to be successful due to political reasons (recall Camdessus’ saying: “we must succeed”). However, the Fund failed even before the reform took off and was sealed by the conclusion of the SBA. It had to resign from seeking mid-term guarantee for its resources. Not only did it fail to get the initial consent for the Polish debt to be reduced, but also failed to obtain this assurance in any definite form.

This was due to resistance of creditors who were reluctant to support the debt reduction idea. In 1990, they were postponing the issue of reduction in negotiations with the Polish government for such a long time that the latter began to doubt (although only temporarily) the possibility to obtain reduction from the Paris Club and started considering other extraordinary solutions to the debt problem. Regardless of whether the Paris Club postponed the reduction to force Poland to strictly adhere to the IMF program or for fear of setting the precedent, this situation proved that the Fund, despite having forced through its vision of the strategy towards Poland, was still limited in the implementation of this strategy by the Paris Club countries. Gaining approval for debt reduction for Poland was too important an issue to give in to pressure exerted by the IMF and give a green light to it at once. In order to obtain approval for the reduction, the Fund, therefore, had to strongly commit to make the unique reform in Poland succeed. The Fund’s own credibility was at stake here as depending on the fate of the

[313] IMF Archives, Poland, Correspondence and Memos, March 1990, File 3. *Your Meeting with Mr. Mazowiecki*, M. Russo to the Managing Director, March 21, 1990.

Polish reform it would be confirmed in the form of later cooperation with countries undergoing transformation in the region, including the USSR. This unique support for the unique reform in Poland made it stand out among other IMF programs being implemented at that time.

1. The Fund's struggle for debt reduction

The problem of a large trade surplus[314] achieved in the first two quarters of 1990 had a negative impact on the debt reduction negotiations. At the end of April 1990, during a conversation between Prime Minister Mazowiecki and Director of Research Department in the IMF Jacob A. Frenkel, the former expressed his concern that the significant improvement in the trade balance weakened the Polish bargaining power in negotiations on debt reduction.[315] Good foreign trade results questioned balance-of-payments scenarios made to convince creditors to grant debt reduction of a considerable scale to Poland.

In this situation, the Fund could not refer to the unpredictable reaction of the economy undergoing shock treatment to justify exceptional financial support for the Polish government. Instead, it tried to decrease the meaning of the trade surplus for the debt reduction issue. At a meeting of Polish delegates with the Paris Club held in June 1990, an IMF representative started by stressing that until that time, the reform implementation was excellent.[316] He then argued that the balance-of-payments results for the first five months of 1990 were good, but "simple extrapolation was not warranted." In other words, the trade surplus was a phenomenon of a temporary nature and, more importantly, would turn into a deficit in short time. This would take place because Polish economy underwent an "unprecedented shock", as a result of which it experienced a collapse of imports, yet "as conditions normalize, imports should pick up sharply."[317] What is more, as far as good trade performance was not envisaged

[314] A hard-currency trade surplus of nearly 4 billion dollars was created as a result of a deep devaluation of zloty and a reduction in domestic demand produced by the stabilization program.
[315] IMF Archives, Poland, Correspondence and Memos, May-June 1990, File 5. *Your Meeting with Prime Minister Balcerowicz*, Jacob A. Frenkel to MD, May 8, 1990.
[316] IMF Archives [...], *Poland Paris Club Working Group. June 13, 1990*. June 15, 1990.
[317] Ibid.

in the reform program, an import surge was assumed in the program as one of the premises of economic growth.[318]

Hence, the representative of the Fund attempted to reactivate the 'uncertainty argument' by showing that the adjustment program would only then have a negative effect on the trade balance and give rise to large financial needs that justified the granting of debt reduction to Poland. The above argument about the temporary nature of trade surplus had also another objective. When the reform program resulted in such a great trade surplus, it gave an impression that Poland regained its payment capacity. Hence, private creditors started demanding immediate payment of the interests due. In turn, Western governments would not demand payments until 1991 when the Paris Club Agreement of February 1990 granting the debt service suspension expired.

To strengthen chances for debt reduction, the IMF accentuated the fact that not only was the government insolvent at the time (as the surplus was temporary), but even should not regulate foreign liabilities in the near future if the reform was to be continued. The IMF representatives, unable to use the 'uncertainty argument' or the argument about the drastic implications for the economy under the shock therapy, referred to another economic argument that pertained to the reaction of the economy to the radical option only. They claimed that continuation of the reform depended on the Paris Club's consent to debt reduction, since ongoing debt service was in conflict with the anti-inflationary objective of the adjustment program. According to the Fund, "the debt-service problem was very much a fiscal one" and the success of the inflation stabilization operation depended on reduction of both private and official debt.[319]

The Fund's line of reasoning is worth citing as it had an important impact on justifying the debt reduction granted to Poland in April 1991. The IMF representative touched on the issues already addressed in Camdessus' letter to creditors from January, i.e. the Paris Club interest in granting reduction and its responsibility for the success of the unique reform in Poland. The arguments used by the Fund were as follows. First, from the very beginning, "the economic program was designed to revive activity in the newly untrammeled economy", that is, it was expected to bring results only if the government was not under constraint of continuing debt

[318] "For 1990, due recognition needs to be given to the link between economic liberalization, especially external liberalization, and the demand for imports, as well as to the potentially disruptive impact of restructuring on exports in the short run"; *The Government's Memorandum on Economic Policies*, December 22, 1989; Polish Transformation, Documents and Analyses, 1968-1989, p. 694.

[319] IMF Archives, Poland, Correspondence and Memos, May-June 1990 File 5. *Paris Club Working Group on Poland June*, Statement by Fund staff representative, January 13, 1990.

payments to creditors. Second, the current excellent trade balance was obtained at the cost of lower budget expenses and conservation of assets, hence, at the cost of growth that was the ultimate goal of the entire reform. Hence, if the government was to continue the anti-inflationary program and debt service at the same time, this would require permanent and massive taxation by the government, for this was the only non-inflationary way of purchasing necessary foreign exchange. Such a high level of taxation, however, would promptly stifle activity, and hamper Poland's integration in the global economy.[320]

The above ‘fiscal’ argument was taken into account by creditors when negotiating reduction with the Polish government and the IMF. The former attempted to convince the Paris Club that a more beneficial effect for the reform would be achieved through reduction of current interest payment than future principal installments.[321] Hence, debt reduction would directly relieve the budget and thus decrease inflationary pressure. Attention of the Paris Club was also drawn to additional negative consequences of massive taxation as the only way for servicing debt by the Polish government. This would negatively impact external account viability in the mid-term and increase debt overhang. Additional taxation of citizens to improve foreign exchange reserves would discourage domestic and foreign investors, who thereby would be concerned about their business in Poland.

The main pillar of all these arguments was an attempt to convince creditors that quick inflation stabilization in Poland is in their immediate interest and that overcoming inflation and restroing credibility are inherently connected. Only debt reduction would ensure that the anti-inflationary program was continued and the debt overhang eliminated. In short, the IMF made it clear to Western governments that the success of the Polish reform was in their hands.

2. Trichet’s alternative to debt reduction

Despite all these efforts, chances for debt reduction in mid-1990 were still low. Below, I present the Paris Club’s fundamental criticism of the very postulate of debt reduction made by Poland. I then proceed to describe the reaction of the Polish government, which at a certain moment stopped believing that obtaining the reduction was even possible. At the end of the

[320] Ibid.
[321] Author’s conversation with S. Gomułka.

chapter, I focus on the causes of a breakthrough in negotiations with creditors and of creditor's improved capacity to grant debt reduction.

At the meeting in June, President of the Paris Club Jean Claude Trichet openly expressed his disapproval for the Polish debt strategy, focusing his criticism particularly on the demand for an 80 percent debt reduction. He drew Polish negotiators' attention to the fact that by insisting so strongly and so long on such an extensive debt and debt service reduction, they fled to „realms of fantasy" and could ultimately reach a dead end.[322] He then attempted to dismiss hope for obtaining the reduction of this scale by comparing Poland's situation to that of many African countries. In the case of the latter, the Paris Club was prepared to offer terms that amounted to 30 percent reduction. Trichet asked then rhetorically: "was it likely that the Club would offer more generous terms to a richer country like Poland?"[323] President of the Club demanded from the Polish government a requirement for new money both from commercial banks and the governments, since if Poland took into consideration new loans, its mid-term scenarios would not look that bad. Lastly, Trichet strongly criticized Polish delegates when they claimed that private banks made their approval for debt reduction conditional on prior consent of the governments. According to Trichet, putting the issue in such light was clearly just a negotiating ploy.[324]

Trichet made it clear for Poland that the reform that was being implemented did not give strong enough arguments for the reduction. Therefore, instead of "a priori debt cancellation" that would be compulsory for creditors, Trichet made his own proposal for Poland on behalf of the Club. He claimed that it would be possible to get an agreement on an appropriate level of Polish debt service, in relation to objective parameters like exports or current account. Trichet argued that "if Poland's exports grew fantastically, they would repay more; if exports grew slowly, they would repay less; in any case debt service would not be permitted to hamper the development of the Polish economy."[325]

The above proposal was based on economic grounds, just like the IMF arguments. The latter demanded debt reduction as a means for preventing the desired effects of shock therapy from evaporating. Interestingly, Trichet proposed the negotiation of a debt service relief with

[322] Although Trichet used this term to refer to the Polish delegates' stubborn demand for the 80 percent debt reduction, the fact is that a lower scale of reduction for Poland was not taken into account in official negotiations until the end of 1990.
[323] IMF Archives, Poland, Correspondence and Memos, May June 1990 File 5. *Poland Paris Club Working Group. June 13, 1990*. June 15, 1990.
[324] Ibid.
[325] Ibid.

Poland that would also ensure success of the reform in the form of sustained economic growth and give precedence to the need for implementing the radical reform. In this sense, his proposal had the very same objective as economic arguments used by the IMF: the 'uncertainty argument' (the government could not repay the debt since no one knew how the economy would react to a 'rapid transition') and the 'radical reform argument' (the enormous scale of the GDP fall would require balancing the current account to be postponed). However, what made Trichet's proposal different to the two proposals of the Fund was that it could help Poland in the same way as these other two could, with the latter demanding reduction, yet without granting it.

The Polish government replied with an unclear initiative to side-step the Paris Club in their attempt to obtain a considerable financial relief. In a document to Camdessus before the conversation with Polish delegates prior to the Forty-Fifth Annual Meeting in 1990, Allen advised him to consider the modalities and outlook for closing Poland's prospective financing gap over the next few years in light of the tough stance of the Paris Club concerning debt reduction. Allen foresaw that Balcerowicz would want to sound out Camdessus on side-stepping the Paris Club and seeking a broader international institution to address Poland's financing needs.[326] Another Allen's document on this matter, this time addressed to Russo, involved specific proposals of these modalities. At the beginning, Allen explained that the Poles were concerned by the reluctance of the Paris Club to do anything serious on debt reduction.[327] Thus, Poland lost its faith in the possibility to come to terms with the Paris Club on that issue and sought another way of raising additional resources for Poland from the official sector. As an example of such a way of side-stepping the Paris Club, Allen mentioned a consultative group or a consortium through which the government or the IMF could put these issues to the OECD governments, and seek a large financial contribution.

Allen's concerns gave rise to an image of a quite hopelessness prospect for Poland, as it turned out any initiative to side-step the Paris Club eventually boiled down to... this Club's assistance. Allen, who was not in favor of the Polish initiative, doubted if there was any way of mobilizing assistance that could be better done than through the Paris Club countries. Moreover, the IMF did not want, due to image concerns, to become engaged in the initiative to convene an international group on the matter of meeting financial needs of Poland, as this

[326] IMF Archives, Poland, Correspondence and Memos, September File 2, *Brief for Meeting with Delegation*.
[327] IMF Archives, Poland, Correspondence and Memos, September File 2. *A possible consultative group or consortium, M. Allen to M. Russo*, September 18, 1990.

could mean entering an area reserved for, e.g. the already existing PHARE program.[328] On the other hand, Allen concluded his memo admitting that Poland was right and expressing his doubt whether the OECD really wanted to help Poland proportionally to the economic effort taken by that country.[329]

3. EFF breaks the ice

Below I attempt to prove that the Paris Club's resistance to debt reduction was ultimately overcome by a perspective for the continuance of the rapid transition reform in the form of a new three-year reform program agreed upon with the IMF. This argument was significant as Trichet, in June, in fact made it clear to Poland that the *existing* reform did not justify the 80 percent high debt reduction or maybe even debt reduction as such.

In the context of Poland's persistent demands of debt reduction, in a September conversation Vice President of the Paris Club Denis Samuel LaJeunesse recalled Russo that "Poland had received the most generous rescheduling ever and that the capitalization of moratorium interest was unprecedented."[330] However, he immediately added that "during the next program, the Paris Club would give whatever relief is required."[331] The wording "whatever relief" meant a consent to debt reduction[332], yet not aside from or during the current IMF program in any way, but only as part of a new agreement. Hence, Vice President of the Club stressed that the new program should be a three-year one[333], for only that time framework for the new IMF program could be considered a guarantee for Poland's credibility to Western governments.

Until that time, the Club did not succeed in obtaining such a guarantee. Poland expected to receive consent for official debt reduction immediately after being granted an exceptionally favorable rescheduling in February 1990. Then, it expected approval for the reduction when implementing the stand-by program concluded also in February 1990. In both cases, Western

[328] Ibid.
[329] Ibid.
[330] IMF Archives, Poland, Correspondence and Memos, September 1990, File 2. *Meeting with Mr. Samuel-Lajeunesse*, M. Russo to MD, September 14, 1990.
[331] Ibid.
[332]In 1991, the debt relief was extended to Poland in three ways (depending on preferences of a creditor): debt reduction - reducing the principal or face value of the debt; debt service reduction - reducing interest rates; capitalization of the interrest payments and reduced interest rates.
[333] IMF Archives, Poland, Correspondence and Memos, September 1990, File 2. *Meeting with Mr. Samuel-Lajeunesse*, M. Russo to MD, September 14, 1990.

governments did not want to agree and even openly manifested their irritation with Polish negotiators putting this matter in such light. Their never-ending questions about debt reduction were not taken seriously by the governments who stated there was no urgency since the current agreement with Poland did not expire until March 1991.[334]

In turn, conclusion of the three-year EFF program would prove both determination in continuing the reform and, primarily, Poland's credibility in the form of a successfully completed SBA concluded in February 1990. According to Vice President of the Paris Club, Western banks should also treat the approval by the IMF of the EFF as a guarantee of Poland's solvency. However, since banks still did not accept the decisions made on the Polish debt by the IMF-Paris Club-Polish government triangle, and without their participation the mid-term financing gap could not be closed, Samuel-LaJeunesse warned the IMF against giving in to that "bank blackmail".[335] This stance of the Club proved that until that time, it feared not as much the emergence of a precedent by granting debt reduction but the lack of a tangible guarantee of Poland's solvency. Once it received it in the form of the EFF, it saw no obstacles to seeking consensus on the debt reduction issue.

The shift that the Paris Club's stance caused by the imminent perspective of the EFF was confirmed during a meeting in October with Polish delegates when the issue of the debt reduction emerged and was finally treated as a real-life scenario. However, Trichet still perceived the rescheduling or debt swaps as more probable options. Although these were to be granted to Poland on exceptionally favorable terms, it is out of question that both these solutions were far less beneficial than 'clear' reduction. President of the Club also suggested to Polish delegates that it was their turn to make a move. After heavily criticizing their stubborn attitude in demanding the 80-percent reduction, when asked at the October meeting by the Polish delegates what scale was real, he did not reply "none", as he used to think in June. Moreover, at the very same meeting, representatives of the American, British and German governments declared they were ready to take debt reduction into consideration. A French representative hesitated, while a representative of Japan strongly rejected this possibility.

It is worth to note here that as early as May 1990, at the Bretton Woods Committee meeting devoted to the issue of financial assistance for the Central European countries undergoing

[334] IMF Archives, Poland, Correspondence and Memos, October, File 3, M.Allen and M. Kuhn to MD, *Paris Club Working Group on Poland*, October 13, 1990.
[335] IMF Archives, Poland, Correspondence and Memos, September File 2. *Meeting with Mr. Samuel-Lajeunesse*, M. Russo to MD, September 14, 1990.

transformation, representatives of the Polish government were told by David Mulford, the US Under Secretary of Treasury, and Michel Camdessus, that Poland deserved special treatment in the region and they promised taking „special measures" leading to a relief in the debt burden on the performance of the Polish economy.[336] Interestingly, the representative of Czechoslovakia, the Minister of Finance Vaclav Klaus, called for a slowdown in the pace of financial assistance from Western governments as it helped preserve old production structures and, as a result, weakened the process of economic transformation.[337] Statements of this kind worked in favor of the Polish demands for debt reduction. While Mulford justified the need for substantial debt relief for Poland with the ongoing program of macroeconomic stabilization[338], Camdessus made it clear to the Poles that debt reduction should take place as part of the negotiations on the medium-term program with the IMF in the second half of the year.[339]

4. Ultimatum of the Fund

Both earlier and at that time, the IMF in the negotiations with the Paris Club clearly made the prospect of the cooperation with the Polish government conditioned on obtaining financing assurances from Western governments beforehand. This condition was stressed by the Managing Director in his January letter to the Club sent several days before the meeting of the Executive Board, when the 13-month stand-by program was approved. Also, in his memo from November 1990, one of the key representatives of the Fund Manuel Guitian wrote: "What is clear [...] is that financing assurances extending over a period of years will be required prior to the Fund's commitment of resources."[340] He then declared an intent to make "informal soundings bilaterally with Executive Directors of key Paris Club countries on how this issue might be approached."

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[336] *Sprawozdanie dotyczące udziału w spotkaniu w Bretton Woods Committee [Report on the participation in the meeting of the Bretton Woods Committee*], May 28, 1990. Archives of the Ministry of Finance; Foreign Department; A/822/22 (March 20, 1989 - June 26, 1990, 302 pages).
[337] Ibid.
[338] Ibid.
[339] *Notatka dot. spotkania Sekretarza Stanu w Ministerstwie Finansów Marka Dąbrowskiego z Dyrektorem Zarządzającym MFW, M. Camdessus* [*Note on the meeting of the Deputy Finance Minister Marek Dąbrowski with the Managing Director of the IMF M. Camdessus*], May 28, 1990. Archives of the Ministry of Finance; Foreign Department; A/822/22 (March 20, 1989 - June 26, 1990, 302 pages).
[340] IMF Archives, Poland, Correspondence and Memos, November-December 1990, File 4. *Poland - Briefing Paper, M. Guitian to MD*, November 6, 1990.

In January 1991, the issue of financing assurances took on new dimensions. Russo informed Camdessus that the magnitudes of the financing gaps and their persistence over time made the case for substantial debt reduction.[341] He also stated that the governments should be given primacy as creditors.[342] He expained that although the new program could be launched without banks' consent to debt reduction (after all, this was the case for the first IMF program in February 1990), it required that official creditors reached agreement on the reduction first. If governments failed to arrive at consensus on that matter, "it would probably be necessary to delay submission of an arrangement to the Board."[343] This second scenario was all the more possible as the Fund received ambiguous signs on the prospect of the G-7 reaching a common position on that matter. Hence, if such a situation took place, Russo claimed, the Fund would have to "launch an initiative vis-a-vis the Paris Club" once again.[344]

At the turn of 1990, the Club demanded that the Polish government made an agreement with the Fund as a prerequisite for the debt rescheduling, yet in January 1991, it was the other way round – the Fund made an agreement on the EFF with the Polish government conditioned on prior Paris Club's confirmation of financing assurances. This proved two thigs. First, the governments were still reluctant to the idea of granting debt reduction. Second, the Fund was highly committed to make the new program with Poland supported by debt reduction.

5. Highly uncertain mid-term scenarios

In June 1990, the Fund attempted to convince Western governments that the unanticipated large trade surplus was temporary, as in short time import needs of Poland would rise and the surplus would turn into a deficit. At that time, it did not assume that this would be mainly due to external factors. In mid-term balance-of-payments scenarios of August 1989, the effect of shock therapy and "phased approach" on the economy was given due account; however, in

[341] IMF Archives, Poland, Correspondence and Memos, Jan-Feb 1991, File 5. *Poland - Briefing Paper*, M. Russo to MD, January 16, 1991.
[342] Ibid.
[343] Ibid.
[344] Ibid.

those drawn up at the turn of 1991, all elements of the balance-of-payments deteriorated in short- and mid-term due to influence of external shocks.[345]

It should be noted that the credibility of balance-of-payments mid-term projections was quite low. This was mainly due to the lack of a universal method for devising and verifying them. Mid-term scenarios developed by the Fund, Poland and private banks happened to be thoroughly different on selected aspects. Already in February 1991, that is, one month before the initial decision was issued by the Paris Club on the debt reduction, Jeffrey Sachs and David Lipton accused the Fund that its scenarios underestimated negative effects of external shocks on the Polish economy.[346] In turn, in November 1990, Massimo Russo stressed in his letter to Vice President of the Paris Club that projections sent to the Club were devised by the IMF staff and they did not in any way commit the Polish authorities. He called them "inevitably highly uncertain" and subject to large potential error.[347] He concluded with a warning that the numbers would be subject to continuing revisions while reviewing matters with the authorities, since Polish scenarios provided for a larger trade deficit due to lower exports to the CMEA due to a deteriorating situation in the Soviet Union, and lower exports to the West as well, due to falling inputs from the CMEA.[348] The balance-of-payments projections were unverified and very often quite different from one another. Hence, Russo himself concluded implicitly that they could not have been decisive.[349]

In this context, it is worth to note that in line with the Paris Club agreement from March 1991, Poland received the first tranche of debt reduction, which meant an immediate and permanent decrease in the stock of debt by 30 percent of the net present value. This reduction took mainly the form of cutting interest payments due to the Paris Club by 80 percent in 1991-1993. This meant that Poland's liabilities to the Paris Club were decreased by over 2.5 billion dollars annually for three years. Therefore, it was by far more than envisaged by any mid-term balance-of-payments projection developed earlier by any side.

Likewise, another strictly economic factor in the debt reduction deliberations also proved not decisive, i.e. specific debt indicators that by necessity were taken into account by the Fund

[345] External shocks included both supply shock, i.e. a sharp rise in the oil price as a result of the Gulf War in1990, and demand shock, i.e. a dramatic decline in demand for Polish export goods resulting from the transformation recession in the USSR and the German Democratic Republic.
[346] IMF Archives, ETRIC, Country Debt Files, Box 7 Poland – Debt File 1983-1991, *Poland's Debt Reduction*, Sachs J. and Lipton D. to Managing Director, February 14, 1991.
[347] IMF Archives, Poland, Correspondence and Memos, November-December 1990, File 4. *M. Russo's letter to the Paris Club Vice-President, Mr. Samuel-Lajeunesse,* November 19, 1990.
[348] Ibid.
[349] Ibid.

and creditors when estimating the scale of reduction. Two weeks before the informal consent to the debt reduction was granted[350], on March 4, 1991, a comparative analysis of selected highly-indebted countries was made in the IMF with regard to deviation of their debt factors from standard. The inability to find the key and exceptional debt-factors that would justify debt reduction for Poland proved that it was insufficient grounds not as much for estimating the scale of reduction, but to granting debt reduction in general. The comparative analysis of Poland, Egypt, Brazil, Hungary, and the Philippines showed that one or two exceptionally bad debt indicators in one country (such as debt service or debt/GDP ratios) were within normal limits in another country, where other factors were by far worse than in the first one.

Thus, the technical justification for debt reduction for Poland, although necessary, gave no grounds for such a reduction to be granted, which was clearly admitted in the IMF analysis. The author of the analysis stated in the conclusion that in light of the comparison with other highly indebted countries, making a case for the reduction of Poland's debt based on debt indicators was not easy.[351] Most importantly, he clearly pointed to one factor that evidenced Poland's uniqueness in its efforts to obtain debt reduction, namely, heavy indebtedness to official bilateral creditors.[352] Ultimately, giving the key role to official creditors and not private ones allowed the Polish reform to receive debt reduction.

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The decisive argument in favor of debt reduction was not the economic reform per se, but its political objective which was stressed so often by Poland. The restrictive financial policy or a complete liberalization of foreign trade were merely a means for reaching the actual goal sought by Western governments, i.e. rapid transition from a socialist system to a free-market democracy.

Already in December 1989, Balcerowicz in his speech in the Polish *Sejm* emphasized this aspect of the need to decisively move away from the inefficient socialist system. In his view, the essence of Polish transformation was the abandoning of the idea of economic socialism that showed people objectives "invented" in the 19th century social doctrines while capitalism offered "concrete and noticeable" benefits. According to this, western credits in the 1970s, served for subjecting the economy to values such as egalitarianism or social justice. In turn,

[350] On March 18, 1991 an initial agreement was concluded between the Polish government and the Paris Club countries on the debt reduction. This was officially confirmed by an agreement signed on April 21, 1991.
[351] IMF Archives, Poland, Correspondence and Memos, March-April 1991, File 1. *Debt Reduction by Official Bilateral Creditors: Country Cases Poland and Egypt vs. Brazil, Hungary, and the Philippines*. March 4, 1991.
[352] Ibid.

the Polish economy in the 1980s demonstrated vividly the bankruptcy of the so-called ‘real socialism’, inherent inability and incompetence of socialist economic policy when deprived of western credit assistance. In terms of quality, the new post-1989 economic policy was based on a clear break with the past, which, consequently, also suggested a specified stance of the new democratic government on the necessity to eliminate foreign debt as a huge drag on the economy inherited from the communist regime.

The argument for debt reduction in the form of the clear break with the past to build a free-market system proved one of the most important used by Polish delegates during negotiations held with the Paris Club representatives on the eve of signing the initial agreement on debt reduction in March 1991. In the course of overnight negotiations, the Japanese Minister of Finance accused the Polish government that it could not be credible, as on the one hand, it demanded that credit contracts concluded in the past be ignored, while on the other, it stated to be building market economy, whose one of the fundamental principles was observance of contracts. In response, the Polish government emphasized that it wanted to “sign a contract that it intends to fulfil in every aspect, while former communist governments used to sign contracts knowing in advance or assuming in advance that they would not be fulfilled, and in this very aspect the present government is different to the former ones. If we are to sign a contract we need to fulfil, it must be a realistic one. Hence, the proposal of debt reduction, as we have to reduce debts to a level at which Poland will be able to serve it and pay it on time. Therefore, this falls within the framework of the market economy doctrine.”[353]

This vast quotation was cited in order to show how important was the role of political argument in negotiations with creditors. Polish negotiators justified their request for exceptional financial support with the fact of conducting an operation of moving away from socialism, which was unique in the historic scale. The essence of the argument pertaining to the clear break with the past was that the foreign debt had to be subjected to the very same logic as the entire economy. In accordance with building a free-market system, all macroeconomic factors were to be made ‘realistic’, hence, also the foreign debt. Since parameters such as interest rate and exchange rate, credit supply or wages were to be adjusted to the real efficiency of the economy being reformed and new market mechanisms, the debt was to be adjusted to the changing payment capacity of Poland as well. A prudent external credit policy was a natural consequence of adopting prudent financial policies, whereas the

[353] *Conversation between Jan Krzysztof Bielecki and Stanisław Gomułka*. In: „Polish transformation.Documents and analysis: 1991-1993”, p. 36

aim of debt reduction was to consolidate these achievements of economic policy. Once the reform was completed successfully thanks to debt reduction, the government would be able to serve the debt on a regular basis.

However, this line of reasoning was possible only when *rapid* departure from the old system was stressed. The pace of moving away from socialist economic policy determined Poland's credibility in the eyes of the creditors because it was a measure of Poland's determination to regain its payment capacity. In the „Agreed minute on the debt reduction" concluded with Poland in April 1991, the Paris Club, when justifying granting of the reduction, refered to Poland's determination in the radical transformation of its economy [emphases added]:

"The representatives of the Governments of the Participating Creditor Countries noted the commitment of the Government of the Republic of Poland to undertake measures of adjustment in the economic and financial sector and stressed the <u>specific importance they attach to the continued and full implementation</u> of the program concluded with the Fund. The representatives of the Governments of the Participating Creditor Countries stressed that they were well aware of <u>the exceptional situation of the Republic of Poland, involved in a transition without precedent towards a market economy, which constitutes a unique challenge</u>. In this respect, they declared themselves ready to apply, in combination with the Republic of Poland's own adjustment efforts, extraordinary debt reduction [...]"

Polish delegates could not have argued for the debt reduction in the above manner if Poland in 1989 had chosen the gradual approach, i.e. an option involving less decisive economic transformation spread over a longer period. Stanisław Gomułka, who was the key economist in the group of Polish negotiators during the final round of the negotiations with the Paris Club[354] claimed that strategic, political aspects played the fundamental role for the Paris Club at that time. In a conversation with the author of this thesis, Gomułka recalled being approached by President of the Paris Club Jean Claude Trichet in March 1991, already after the successful conclusion of the negotiations on the reduction, asking to send his best wishes to Leszek Balcerowicz. He remarked that the Club was aware of the difficulty of the situation he was in as the Minister of Finance and then he stressed: "we want to help him". Gomułka recalled this episode as another prove that in the intentions of the Paris Club, the debt reduction was to increase the chances for the Polish transformation to succeed.

[354] The group of debt negotiators was headed by the Vice Minister of Finance Janusz Sawicki.

Ultimately, the negotiations on debt reduction took place already at the starting point of another stage of the rapid transition reform in the form of the three-year Extended Fund Facility program. This program intended to accelerate structural changes and end the macroeconomic stabilization. In the official explanation, the Paris Club conditioned the full debt reduction on continuance of both the cooperation with the IMF and the “unique challenge”, i.e. the transition to a market economy. In the second part of the thesis, I provide arguments for the statement that this correlation had a decisive effect on the conclusion of the first, fundamental stage of the stabilization-cum-structural adjustment in Poland in the years 1992-1994.

II PART. DEBT REDUCTION ENABLES RAPID TRANSITION

Chapter V. ‘Anchoring’ the reform with debt reduction

Above, I depicted the EFF as the debt reduction catalyst as the general objective of the first part of the thesis, which was to show that the decision on the rapid transition modeled on the West had a decisive effect on Western governments’ consent to the debt reduction. In the next part, I tackle the second part of the thesis, that is, “how did the debt reduction projection allowed for the Polish reform to be continued”.

The new EFF agreement alone was not a sufficient guarantee for the Paris Club that the reform leading to long-term external viability was to be continued. This guarantee was not provided until the debt reduction process was divided into two stages, and hence the second tranche of the official debt reduction was made conditional on the EFF agreement being successfully completed. As mentioned earlier, in the fourth quarter of 1989, Western governments did not grant their initial consent to debt reduction before the launch of the reform in Poland. They were also unwilling to give the Fund ‘collateral’ for its resources engaged in the Polish reform, as they considered it an “ex ante doubtful loan”, that would give rise to a precedent. Lastly, they were concerned that granting the full debt reduction at once would trigger moral hazard effect. The Paris Club feared that the Polish government would move away from the rapid transition reform once it received the full debt reduction at one time. It was a well-grounded concern, as proved by the fact that the Polish government abandoned the EFF agreement immediately after receiving the first tranche of debt reduction in April 1991.

Throughout the year 1990, Poland proposed that the Paris Club granted a one-time irreversible reduction on a scale considerably higher than 50 percent, meaning that it did not provide for the reduction process being divided into phases. However, the Club wanted to make reduction dependent on further reform of the economy. In this very way one should understand Trichet’s words when he told Polish delegates in June 1990 that the Club did not want “debt reduction a priori”, that is, granted before the actual implementation of the adjustment-cum-systemic reform. Eventually, in April 1991, the Paris Club ensured reduction of 30 percent of Poland’s debt, while the second tranche at the level of 20 percent was conditioned on the implementation of the economic policy agreed under the EFF, and was to take place immediately upon the issuance of a positive opinion by the Fund's Executive Board in December 1993.

The EFF was expected to eliminate the risk of Poland's insolvency in two different ways. First, by decreasing moral hazard by dividing the debt reduction operation into two phases and, hence, making its completion conditioned on the conclusion of the IMF-supervised adjustment-cum-systemic reform. Second, the new program limited the risk of Poland's insolvency by obligating the Polish authorities to attain mid-term external viability. In this way, after 1991 the Fund and the Paris Club supervised the establishment and maintenance of internal and external balance in the Polish economy. This was to be achieved by, respectively, a restrictive budget policy and an adequate level of foreign exchange reserves in the central bank.

Before proceeding to how the willingness to obtain the second installment of debt reduction mobilized the Polish government after 1991 to continue the rapid transition reform in cooperation with the IMF, I make an attempt to prove that the perspective for receiving the Club's consent for debt reduction had a fundamental effect already on the implementation of the first SBA program of February 1990. First, however, I want to prove how the willingness to obtain debt reduction translated into an external credit restraint in the Polish economic policy and in a reluctance of the creditors to provide loans to Poland. Next, I show how the perspective of debt reduction translated into a willingness *to complete* the economic program in line with the stand-by agreement concluded in February 1990 with the IMF after the government moved away from this agreement in the middle of the year.

1. External credit restraint

The new government's stance on financing of the reform using credits provided by Western government was expressed in the assumptions and implementation of the first program with the IMF from 1990. The last of the six performance criteria was the New External Debt that specified the limit for new loans taken or guaranteed by the government or the National Bank of Poland (NBP). Characteristically, fulfilment of this criterion not only was not close to the limit but was the only one that was not violated during the cooperation between Poland and the IMF in the years 1990-1994. In its Memorandum of December 1989 (attached to the

Letter of Intent), which was a detailed study of the reform, the government obliged itself to refrain from short-term external borrowing and from extending guarantees for such borrowing.[355]

On the other hand, the government assumed that current account balance could be restored in 1993 "only with a steady stream of new credits."[356] However, both these facts were not contradictory. Foreign credits were one of the forms for ensuring external financing for the reform in case an agreement on debt reduction cannot be reached. This also aimed to stress the essential condition for the reform success, that is, foreign financial assistance. At the same time, the main form of financial assistance in mid-term mentioned in the memorandum was debt reduction: "it will be possible for Poland to begin to regain a viable external position only if the burden of external indebtedness is lightened substantially through debt and debt service reduction". [357] Moreover, Leszek Balcerowicz in his speech at the Annual Meetings in late September 1989 also remarked that the reform could be successful if Poland received permanent reduction of the debt burden to the Paris Club and commercial banks.[358] Below, I make an attempt to show that since it was very uncertain if debt reduction could be obtained in 1990, paradoxically, the government avoided taking new foreign liabilities even more.

The performance criterion of the 'new external debt' estimated the limit of foreign debt in 1990 at 700 million dollars, while in 1991 and 1993, the IMF programs estimated it at 1.5 billion dollars and 1.250 billion dollars, respectively.[359] These were very low sums compared to the financial needs of Poland at the time of such a radical economic reform. As we can recall, the leaders of 'Solidarity' demanded 10 billion dollars from the Western institutions in the course of three years, mostly in the form of loans. Another time, head of the IMF mission in Poland Massimo Russo, when asked by one of the Executive Directors, specified the estimated financial needs of Poland for the period of the reform at 10 billion dollars in grants.[360] The reformers themselves claimed that Poland's needs were at the very same level as the money West Germany had to pay for converting East Germany to a market economy,

[355] *The Government's Memorandum of Economic Policies*, December 22, 1989. Polish Transformation, Documents and Analyses, 1968-1989, p. 694.
[356] Ibid, p.693.
[357] Ibid, p.695.
[358] *1989 Annual Meetings of the Boards of Governors*, p. 174.
[359]*The Government's Memorandum on Economic Policy*, March 1991. „Polish Transformation, Documents and Analyses, 1991-1993", p. 190. *The Government's Memorandum on Economic Policy*, March 1993, Archives of the Ministry of Finance, A/822/29 (May 31, 1991-December 16, 1993, 244 pages).
[360] IMF Archives, Poland, Correspondence and Memos, February 1990, File 1. *Poland - Executive Board Meeting of February 5, 1990*, February 7, 1990.

yet at the same time they realized that they would not ever obtain an amount of such a great scale.[361]

What was the sum considered by Poland? In 1990, a special German Unity Fund was founded in Bonn at the amount of 115 billion Deutsche Mark (about 70 billion dollars) with the intention to support the financing of the German unification. In turn, financial needs of the USSR in one year at the time of the upcoming reform were estimated in 1991 at over 30 billion dollars.[362] Poland needed capital, yet could not borrow abroad, as it knew that in her case only debt reduction could bring several billion-dollar savings. New foreign liabilities would undermine the credibility of the debt reduction postulate that aimed to limit these liabilities. In turn, debt reduction could be obtained only in case when the process of transforming the socialist economy into a capitalist one was concluded. This was Poland's sole asset. It was not covered by a financial umbrella like East Germany were by West Germany. It was not also a country of such a strategic importance for the world as Russia was, not to mention its vast natural reserves serving as the main source of foreign exchange.

The highly careful foreign credit policy of the Polish government would be understandable if the explanation was accepted that Western governments and banks were not willing to grant credits in larger amounts to Poland. Indeed, Poland in the years 1989-1990 was not considered credible either by the Paris Club or banks, and the problem with attracting credit was experienced by the entire region. Still, the lack of credits cannot be explained only or primarily with the low tendency of the West to finance Poland. Although this would be the fundamental obstacle encountered by the Polish authorities on their way towards receiving external financing, yet only after 1991. In turn, in 1990 - as I try to show below - there still was an alternative for Western creditors: either new credits and generous rescheduling or debt reduction.

It should be stressed that the latter was a source of great concern for the creditors. Neither banks nor governments wanted to be the first to take the first step towards reduction of the Polish debt. Banks considered Poland "the converse of the Mexican case"[363] and attempted to convince the Fund that the reduction granted by the Paris Club would primarily be more compliant with the principles of the Brady Plan. On the other hand, the Paris Club believed

[361] IMF Archives, Poland, Correspondence and Memos, September File 2. *A possible consultative group or consortium, M. Allen to M. Russo*, September 18, 1990.
[362] IMF Archives, Poland, Correspondence and Memos, July-Sept 1991, File 3, M. Wyczałkowski, *Poland:Effects of the Reform and Proposed Policies*, July 5, 1991.
[363] IMF Archives, EURAI, Country Files, Poland, 1989 Box 61, *Poland*, J. Prust to M. Russo, May 17, 1989.

banks were unfair towards Poland by expecting their privileged treatment to be continued in entirely new political conditions after 1989 and they thought that a debt reduction made first by official creditors would result in "bailing out banks".[364] Interestingly, however, both sides expected the Polish government to be open to their credit offer. Credits were considered by Western governments the most tangible manifestation of “political money” for supporting democratization. Nonetheless, it also served the creditors as an important argument in negotiations on debt reduction. It was stressed that it had a positive effect on the economy and would improve highly pessimistic balance-of-payments mid-term scenarios, which were so often referred to by the Fund and Poland. The greater the payment’s capacity, the weaker grounds for demanding a large-scale debt reduction or even reduction as such.

For this very reason, the Paris Club expected Poland to stop emphasizing in public the drag of the reform, i.e. debt overhang.[365] Creditors believed that “by emphasizing the debt overhang, the Poles hurt themselves and discourage needed investment”, thus undermine the justification for debt reduction, since Poland was expected to attract investors (which was supported by active credit policy), and not discourage them. Some other time, Trichet complained to an IMF representative that Poland was not asking either the banks or the Paris Club for new money, an absence he found regrettable.[366]

The government knew about the existence of the credit offer for Poland in the West. In the fall of 1990, foreign advisers to Balcerowicz, Sachs and Lipton, when drawing up a proposal that budget expenses be financed through financial support from the West, pointed to specific channels of that assistance. They claimed: “The best available sources of this kind of finance are medium- and long-term export credits granted or guaranteed by foreign export credit agencies. After the Polish economic program was launched in January, many of the Western export credit agencies reopened export credit cover and pledged large amounts of finance. If our memory serves us well, the pledges were [at least 1 billion] from Germany, 400 million from Italy, 400 million from Korea, 900 million dollars from Japan, to mention the largest

[364] Notatka ze spotkania Sekretarza Stanu Marka Dąbrowskiego z John’em Niehuss’em [*Note on the meeting of the Deputy Fiance Minister M. Dąbrowski with John M. Niehuss, the Senior Deputy Assistant Secretary For International Economic Policy, US Treasury]*, May 25, 1990. Archives of the Ministry of Finance, A/822/22 (March 20, 1989 - June 26, 1990, 302 pages).
[365] IMF Archives, Poland, Correspondence and Memos, September, File 2. *Meeting with Mr. Samuel-Lajeunesse*, M. Russo to MD, September 14, 1990.
[366] IMF Archives, Poland, Correspondence and Memos, October 1990, File 3, *Paris Club Working Group on Poland*, October 13, 1990.

offers." [367] The authors also drew attention to the fact that so far Poland had not used much of this finance.

The last of the mentioned facts was confirmed by a long-time employee of the Fund and a Polish immigrant Marcin Wyczałkowski, who in his letter to Massimo Russo expressed his critical stance on the reform that was being implemented in Poland. Considering various possibilities to stimulate economic activity in Poland, he drew attention to the fact that Poland did not utilize much of foreign financing that was at its disposal. According to his estimates, the average monthly use of such resources in 1990 amounted to only 30 million dollars. These were compliant with those of Sachs, who estimated utilization of credits in 1990 at about 400 million dollars.[368] Wyczałkowski and Sachs-Lipton duo draw attention to the very same phenomenon: the Polish government could but did not make use of credits offered by Western governments. This would indicate an intentional credit abstinence of the Polish government. This thesis was confirmed by Leszek Balcerowicz in a book published in 1992, which is a report from the 800 days of the reform implementation. There he wrote directly about "the insufficient ability to draw up investment projects" and the resulting Poland's unreadiness for credit assistance from abroad."[369]

Sachs and Lipton questioned the above justification for the government's credit restraint, which took the form of absent eligible expenditures. They referred to the opinion of a high representative of the World Bank – after all, the largest global institution that dealt with seeking and financing investment projects - who was convinced that a substantial share of capital expenditures in Poland could qualify for such financing. He also referred to his experience in other countries saying that Poland simply lacked expertise in identifying financeable expenditures and thus considered many of them non-eligible.[370]

Why therefore the Polish government did not make use of the generous credit offer of developed countries? After all, it assumed itself that foreign credits could determine attainment of external viability. It appears that the government was driven by reluctance to take new credits due to the old debt and the willingness to receive debt reduction. Wyczałkowski unambiguously claimed, that "it should be remembered that Poland did not

[367] J. Sachs, D. Lipton, *The 1991 budget strategy and choices* , 23.10.1990. Polish Transformation. Documents and Analyses. 1990, p. 516.
[368] Polish Transformation. Documents and Analyses, 1990.
[369] Balcerowicz, L. *800 Dni: Szok Kontrolowany* [800 Days: Controlled Shock], p. 141.
[370] J. Sachs, D. Lipton, *The 1991 budget strategy and choices* , 23.10.1990. „Polish Transformation. Documents and Analyses. 1990", p. 516.

make foreign transfers on account of the old foreign debt." [371] Next, in the context of the large trade surplus obtained in 1990, he added that Poland was accumulating foreign exchange instead of spending it and, and he remarked ironically that King Midas would be proud of such a policy.[372] Likewise, Stanisław Gomułka, who was one of the co-authors of the reform throughout the entire period of 1989-1993 and one of the negotiators of Poland's debt reduction, noted that each meeting of the Working Group of the London Club on Polish debt began with banks placing offers for new credits for Poland. Each time, Polish delegates would refuse by referring to the vast burden of the debt that was still growing.[373]

One could wonder how the perspective for receiving debt reduction would change if the Polish government followed the 'advice' of the Paris Club and the London Club and some of its advisers, who argued that new credits would stimulate economic activity and hence, Poland's payment capacity. However, would that not mean a return to the vicious circle of credit-fueled growth known from the 1970s? Did not that clash with the new quality of economic policy stressed by the new government, the essence of which was the rejection of 'shortcut' support of economic growth? After all, it was the Polish government's objective not as much to increase imports, as to liberalize it. The government aimed at restructuring economy by means of import, which meant stimulating economic activity of Polish enterprises in response to cheap foreign competition, which was to result in production rationalization. Although 'top-down' stimulation of economic growth via foreign credits could bring payment capacity sooner, creditors would then immediately demand payments of their liabilities. And so they did when in mid-1990 Poland accumulated large reserves and the Fund argued that Poland could not pay interest at the time since the reform provided for import liberalization at that stage that was to bring a permanent improvement to the functioning of the economy.

Further in this subchapter, I attempt to show that the Polish government strictly identified the self-financing and restructuring of state enterprises with the attainment of debt reduction that would limit the accessibility of new credits. Nonetheless, I begin by discussing an alternative for the above solution. New credits did not have to exclude the opportunity for obtaining debt reduction. Still, a combination of new money followed by debt reduction would mean that

[371] IMF Archives, Poland, Correspondence and Memos, July-Sept 1991, File 3, M. Wyczałkowski, *Poland:Effects of the Reform and Proposed Policies*, July 5, 1991.
[372] Ibid.
[373] Author's conversation with S. Gomułka.

new credits would alleviate the restrictions of liquidity, to which Poland referred to in rejecting the possibility of repaying Western banks, stressing a lack of "operational reserves".

Furthermore, a greater liquidity of Polish enterprises would contribute to investment growth and lift the 'Laffer curve' higher. Once the curve reached the maximum at a higher level of nominal debt, the scale of the postulated debt reduction would be relatively smaller.[374] Hence, it can be assumed that in this scenario, Poland would get a 30-35 percent reduction.[375] This scale of reduction was envisaged by the Paris Club under the Toronto Terms for African low-income countries. This size of debt reduction was granted by Western private banks to indebted developing Third-World countries. Lastly, this size for Poland was considered by the Paris Club in 1990. However, this scale was unacceptable for the Polish government even if one assumed that the expected 80 percent debt reduction stemmed solely from negotiation tactics.[376]

Although new credits and debt reduction were not mutually exclusive, they were in conflict with long-term external viability and restrictive economic policy aiming to attaing permanent inflation stabilization. In March report from a staff team mission in Warsaw, Russo admitted that rescheduling or/and additional new money would not be incompatible with the program agreed for 1991. However, he also added that new credits would have to be paid someday, and this would have implications on policies in subsequent years.[377] Hence, he suggested the risk of squandering achievements of the restrictive financial policy, which served as the basis for the stabilization operation. Conducting such an expansionary policy fueled by flows of new credits would result in another debt trap. Moreover, the Fund saw granting debt reduction to Poland as a guarantee that the prudent economic policy would be continued, since that significant debt relief would eliminate in mid-term the need of new credits from Western governments. As we can recall, these governments assumed support for Poland in the form of 'political money' from the very beginning, which indeed meant a combination of rescheduling and new credits. The Fund had a more strategic line of reasoning. In its view, "debt reduction

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[374] Antonowska-Bartosiewicz I., Małecki W., *Zadłużenie i kapitał zagraniczny a stabilizacja i transformacja* [*Indebtedness and Foreign Capital versus stabilization and transformation*], in: Kołodko G., *Polityka finansowa-Stabilizacja-Transformacja* [*Financial Policy-Stabilization-Transformation*], p. 193.
[375] Ibid.
[376] The reformers have divergent opinions on this matter. In my conversation with Balcerowicz I learned that the 80 percent scale debt reduction was invented for negotiations only, so that this was a price one could go below. However, Stanisław Gomułka claimed that the reduction of this scale was an adequate reflection of Poland's financial needs of that time.
[377] IMF Archives, Poland, Correspondence and Memos, March –April 1991, File 1. *Poland*, M. Russo to MD, March 5, 1991.

would reduce the need for further concessional flows and thus accelerate the return to normal creditor-debtor relationships."[378]

It is worth to emhasize this link between the reasonable credit policy and Poland's credibility as a 'normal' debtor. The Fund assumed that credit abstinence as a consequence of pursuing debt reduction was to serve reestablishing of normal debtor-creditor relations. These relations were to be based on such an economic policy that would make the economy solvent, i.e. adjust payments due to creditors with the debtor's capability. Concessional flows as an alternative for debt reduction in covering the financing gap were risky for the sole reason that they entailed the risk of the debt being rolled over, making the debtor dependent on subsequent credits used to cover the payments due. It is difficult to avoid historical connotations: from the end of the 1970s, this method of debt financing resulted in a debt spiral, which in turn led to an announcement of bankruptcy with respect to Wester creditors in 1981.

Thus, the new credits were in conflict with the spirit of the reform launched in Poland in 1989, the perspective of attaining permanent external viability and stabilizing relations with creditors in the long term. On the other hand, debt reduction, though vital neither for the repayment of the Fund's resources nor for the interim reform implementation, could consolidate the achievements of the reform by a significant decrease in liabilities to be paid in the second half of the 1990s.

The above alternative (preferential new credits *now* or an uncertain perspective of debt reduction *in the future*) was still actual at the turn of 1991 when the issue of debt reduction entered a decisive stage. In Memorandum of March 1991, which determined the objectives and directions of Poland's economic policy for the years 1991-1993, the government expressed its willingness to commit to prudent credit policy, which it considered a highly important element of debt reduction justification. Poland stated that "the fundamental condition for debt reduction is that the available resources be used efficiently and the growth it facilitates be sustainable. In this context, in addition to ensuring that enterprises are subject to firm financial discipline, we intend to ensure that official or officially guaranteed external borrowing is prudent and concentrated on the financing of high priority infrastructure projects." [379] This quotation can be perceived as evidence of the government's determination

[378] IMF Archives, Poland, Correspondence and Memos, March-April 1991, File 1. *Debt Reduction by Official Bilateral Creditors: Country Cases Poland and Egypt vs. Brazil, Hungary, and the Philippines*. March 4, 1991.
[379] *The Government's Memorandum on Economic Policy*, March 1991. „Polish Transformation. Documents and Analyses, 1991-1993", p. 181.

to conduct a clear break with the past. The government declared that having received debt reduction, Poland's credit policy would become very prudent and subject to firm financial discipline. In short, the credit policy would adjust to hard budget constraints imposed by objective market criteria. Importantly, this was in sharp contrast to the central financing of socialist enterprises whose scale was determined by their needs and not efficiency.

This confirms that the authorities *intentionally* obliged themselves to credit abstinence in view of receiving debt reduction. If Poland sough credits before receiving reduction, it would find itself in a much worse negotiation position. Nonetheless, more importantly, the government pointed in the Memorandum to a correlation between debt reduction and effective building of a free market system. This argumentation draws attention to the correlation between the granting of debt reduction that would adjust the government's payment capacity to the possibilities of the restructured economy on the one hand, and the implementation of reasonable investment projects (based on hard instead of soft budget constraints), efficient and prudent use of credits and the attainment of a sustainable economic growth on the other. Thus, in its Memorandum the government seemed to tell Western governments that Poland would never go back to the erroneous 'shortcut' policy of the 1970s.

2. The 1990 Paris Club Agreement as a prelude to debt reduction

In this subchapter, I provide arguments for the highly important role played by the above correlation that determined the actual *timely* completion of the first stand-by program with the IMF of February 1990. This would be the second proof (aside from external credit restraint) that this correlation had a retroactive effect, i.e. the authorities followed it before it was officially formulated in 1991.

In February 1990, Poland concluded an agreement with the Paris Club on very generous terms. As a result of this agreement, Poland was not required to make any payments on pre-cutoff date debt[380] to Paris Club creditors in 1990. According to the Fund observers, the rescheduling agreement with Poland was "the largest and most comprehensive ever in terms

[380] Pre-cutoff date debt referred to payments due to credits taken after 1984. However, since Poland was under the credit blockade of Western governments after martial law was imposed at the end of 1981, the credits it was granted were minuscule.

of coverage."[381] The very long maturities granted to Poland were previously reserved only for low-income countries. According to the representatives of the Paris Club, the rescheduling was very generous and in certain respects unprecedented[382], and it was the very special character of the Polish situation that justified granting of such exceptionally good terms.[383]

The Agreed Minute consolidated 9.4 billion dollars of pre-cutoff date obligations. They comprised all arrears outstanding at the end of 1989 (3.5 billion dollars), all payments due in 1990 (3.9 billion dollars), and all payments due in the first quarter of 1991 (1.5 billion dollars). These amounts were to be repaid over 6 years after 8 years of grace period. All moratorium interest (0.5 billion dollars) was capitalized[384], with 70 percent rescheduled over 12 years and the remainder deferred to end-March 1991. The remaining 30 percent of moratorium interest was to be paid during the first quarter of 1991.[385]

Nevertheless, Polish delegates did not stop at the attained agreement and pushed for some settlement towards the future debt reduction. This pressure was manifested in the Polish delegates' initiative to add a special 'side-letter' to the Agreed Minute, which was to be sent by President of the Paris Club to the head of the Polish delegation of negotiators. The aim of this annex was to make official creditors obliged to establish a Working Group with Poland to examine the issue of the debt reduction. This proposal evoked irritation among representatives of the Paris Club. All the more so, that they treated the letter they received one week earlier from Prime Minister Mazowiecki as a form of blackmail. As we can recall, this letter indirectly made the success of the historical economic reform in Poland, which could contribute to „the rapprochement within the divided Europe", dependent on granting debt reduction. Hence, the creditors were unanimous in their unwillingness to the establishment of such a special group and they stressed that debt and debt service reduction was out of the question in this round of rescheduling.[386]

[381] IMF Archives, Poland, Correspondence and Memos, February 1990, File 2. *Paris Club Meeting, February 12-16, 1990*, February 22, 1990.
[382] IMF Archives, Poland, Correspondence and Memos, September 1990, File 2, *Meeting with Mr. Samuel-Lajeunesse*, M. Russo to MD, September 14, 1990
[383] IMF Archives, Poland, Correspondence and Memos, February 1990, File 2. *Paris Club Meeting, February 12-16, 1990*, February 22, 1990.
[384] Interest capitalization is a conversion of interest due into principal. It serves for including interest payments to debt restructuring program instead of regular payments outside the agreed restructuring.
[385] IMF Archives, Poland, Correspondence and Memos, February 1990, File 2. *Poland - Paris Club*, P. Hole to MD, February 22, 1990.
[386] IMF Archives, Poland, Correspondence and Memos, February 1990, File 2. *Paris Club Meeting, February 12-16, 1990*, February 22, 1990.

Ultimately, a compromise was made, which was Poland’s success after all. The side-letter confirmed that the creditors were prepared to meet with representatives of the Polish government “to examine matters relating to Poland's financial obligations to Paris Club Governments.”[387] As can be seen, the aim of convening such a group was formulated in deliberately general terms. The avoidance of the term ‘reduction’ in the official stance of the Paris Club representatives was a good reflection of their reluctance to the idea of debt reduction as such. However, it was obvious that the case of pushing through the side-letter was about nothing but reduction. It was the sole argument used by Poland to justify the forming of the Working Group in negotiations with the Club representatives. Likewise, Peter Hole, who was present at the negotiations as the IMF representative, confirmed that the Working Group was to be formed to discuss future debt reduction since “no one thought that the terms of reference could be limited to something less.”[388]

Eventually, the agreement signed in February titled “Agreed minute on the consolidation of the debt of the Republic of Poland” stated that [emphasis added] “the provisions of the present Agreed Minute will continue to apply provided that the Government of the Republic of Poland continues to have an arrangement with the International Monetary Fund in the upper credit tranches”, and that “Creditor Countries agreed in principle to <u>a meeting to consider the matter of the Republic of Poland's debt service payments falling due after March 31, 1991</u> [...] provided that the Republic of Poland continues to have an arrangement with the International Monetary Fund involving the use of the Fund’s resources in the upper credit tranches.”[389]

Hence, Poland’s success lay in the fact that it was not just the operation of debt service suspension that was covered by the „Agreed minute”, although it alone exceeded the standards adopted by the Paris Club, but also working meetings on debt reduction conditioned on orderly implementation of the IMF program. And it was those meetings that Polish delegates were highly focused on from the beginning. The agreement with the Club was hence doubly unprecedented for Poland, which achieved two key goals at the same time, namely, suspension of debt service in 1990 and continuation of negotiations on debt reduction.

This conditioning for the Club’s consent for Working group meetings determined a joined decision to hold meetings to examine matters relating to Poland's debt (de facto reduction)

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[387] IMF Archives, Poland, Correspondence and Memos, February 1990, File 2, *Poland - Paris Club,* P. Hole to MD, February 22, 1990.
[388] IMF Archives, Poland, Correspondence and Memos, February 1990, File 2. *Paris Club Meeting, February 12-16,* L.A. Whittome to MD, February 22, 1990.
[389] IMF Archives, Poland, Correspondence and Memos, February 1990, File 2, *Agreed Minute on the Consolidation of the Debt of the Republic of Poland*.

and implementation of the IMF program. This meant a pressure for continuing the restrictive financial policy for full 13 months of the SBA if Poland wanted the debt reduction issue to be maintained during discussions with the Paris Club. If the implementation of the stand-by program was interrupted, the condition for the continuance of Working group meetings would be unmet and Poland's initiative it struggled for would fall.

Peter Hole was impressed by the assertive stance taken by Polish delegates. Pushing forward such a bold postulate in the form of a side-letter on debt reduction entailed the certain risk of the newly concluded unprecedented Paris Club Agreement being rejected by the Club. In Hole's view, this irritation of creditors "should dissipate in time, especially if Poland adheres to its economic program. Indeed, in that event, the side letter could represent a step toward advancing the debt strategy."[390] It should be emphasized that the meaning of the Polish initiative of the side-letter was that Poland obliged itself on its own initiative to implement the stand-by agreement in line with the IMF provisions by the willingness to keep the debt reduction issue on the agenda.

3. Prospect of debt reduction accelerates the reform

Together with the implementation of the reform the political situation in the country deteriorated, which was not without effect on the government's ability to continue cooperation with the IMF under SBA. In the third quarter of 1990, a discussion on aborting the current program and replacing it with another was undertaken in bilateral negotiations. In this situation, could meetings of Polish delegates with the Paris Club be continued? If the agreement with the IMF was terminated, the Club would also terminate the rescheduling agreement under the Agreed Minute, and thus Working Group meetings would be unjustified. As a result, the prospect of debt reduction would not be lost irretrievably, possibly, but it would definitely become substantially postponed.

Further implementation of SBA'90 was hindered by an aggravated social and political situation in the country. In 1990, conditions for the implementation of the radical reform much worsened compared to the political situation from the end of 1989. There was a growing criticism of the economic program from many economists, social protests

[390] IMF Archives, Poland, Correspondence and Memos, February 1990, File 2, *Poland - Paris Club,* P. Hole to MD, February 22, 1990.

strengthened, a ‘war on the top’[391] broke out with the key role played by criticism of the Balcerowicz Plan. There was a growing need in the government as well to address such concerns as low living standards and declining economic activity. Although, unavoidably, mounting social costs created by the reform were used in the current political struggle, the reformers themselves also felt the need to revise existing economic policy. As early as in April 1990, in his letter to Balcerowicz, one of his closest advisers Stanisław Gomułka expressed his concern about the current state of affairs. He wondered whether they were not doing “something really foolish” by pursuing excessively tight policy against the program's assumptions.[392] In his view, continuation of shock therapy “threatened a crisis on the scale of the Great Depression of the 1930’s, and that would not be accepted by either ‘Solidarity’ or its political background in society.”[393]

As a result of this internal and external pressure, the program was made looser in the summer of 1990. This was reflected in the cooperation with the IMF and, hence, also in the cooperation with the Paris Club. A relevant provision in the Agreed Minute of February 1990 referred solely to one meeting of the Working Group, yet in practice, subsequent meetings depended on whether the reform was consistently implemented. The first meeting of the Working Group envisioned in the side-letter took place in June 1990. The ‘green light’ was granted in the form of a positive review issued by the IMF Executive Board that was very impressed by Poland’s determination to implement the reform.[394]

Whether the second meeting of the Group would take place was not that obvious. Poland failed to meet performance criteria determined for the third quarter regarding wages and net domestic assets (NDA). Therefore, it commenced negotiations on waivers[395] for that quarter

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[391] „War on the top” (pol. *Wojna na górze*) - a serious and lasting rift in the post-Solidarity camp that began during the Presidential campaign in the second half of the 1990 when Lech Wałęsa and Tadeusz Mazowiecki competed with each other. However, the conflict began even earlier as Wałęsa’s irritation grew at the increasing domination of intellectuals in ‘Solidarity’. Eventually, ‘the war on the top’ consolidated in the split in the post-Solidarity political camp in Poland between the camp around Mazowiecki, Geremek and other liberals (or ‘intellectuals’) and the camp around Wałęsa grouping traditional, conservative politicians. This split proved to be permanent and its effects can still be seen in the political divisions of Poland today.

[392] The ‘letter of intent’ predicted for the first quarter a decrease in the real value of M3 (broad money) by 23 percent, and increase in prices by 75 percent. Meanwhile, the policy of the National Bank of Poland brought the nominal growth of money much lower than assumed, whereas prices increased by 132 percent. As a result, the real value of M3 decreased not by 23 percent, but by 51 percent. Hence, the departure from assumptions of the program was enormous. S. Gomułka to L. Balcerowicz, *On the concerns about NBP monetary policy*; Polish Transformation. Documents and Analyses, 1990; p. 224.

[393] Ibid.

[394] IMF Archives, Correspondence and Memos, File 5. Message from P. Hole to J. Boniuk (Director of the Foreign Department in the MoF, Warsaw), June 7, 1990.

[395] The purpose of ‘waivers’ was to change the performance criteria to allow further implementation of the IMF program. Waivers to Poland were granted at the end of 1990, “Rozmowa Druga” [Second conversation between T. Kowalik and S. Gomułka], “Polish Transformation. Documents and Analyses. 1990”, p. 71.

and obliged itself to take corrective actions in case the agreed limits were exceeded in the fourth quarter. Under this condition Executive Directors agreed in September to grant waivers to the Polish government. As a result, the second meeting of the Working Group took place in October regarding debt reduction. However, waivers were not granted, since in November the Fund mission realized that performance criteria would probably be unmet also for the fourth quarter. The situation became critical, since both parties were close to terminating the stand-by agreement.

I argue that it was primarily the prospect of concluding the debt reduction agreement with the Paris Club that motivated Poland to take corrective actions that eventually convinced the Fund to grant waivers and, owing to this, the SBA program could be completed according to the schedule agreed on in February 1990. This, in turn made the second agreement with the IMF possible in April 1991 and under that agreement, the agreement with the Paris Club on conditional debt reduction. Below I try to show that at the turn of 1991, both for the IMF and for the government the main advantage of continuing the current SBA program was to maintain the possibility for an *imminent* debt reduction, an objective to which the government's actions in the field of macroeconomic stabilization were subjected.

First of all, at the end of 1990, the fundamental and most socially harmful part of the reform had already been implemented. For 9 months (from September 1989 to June 1990), the new democratic government in Poland succeeded at something not only Western governments but also the IMF itself could did believe in.[396] The Polish government made a revolutionary step forward toward regaining credibility – both financial one and that intangible 'european' one, understood as consistent implementation of the Western path to economic wellbeing. The criterion for assessing the success of the Polish reform abroad was the fact that within 6 months its most interim and urgent objective, i.e. suppression of inflation, was achieved. Although it was too early to talk about permanent price stabilization, the fact that in August prices rose by less than 2 percent compared to the hyperinflationary levels of the fourth quarter of 1989 made a huge impression abroad.

Another positive effect of the reform from the first six months of 1990 was the already mentioned overperformance of the net international reserves (NIR) criterion stemming from unexpectedly good export performance. For a short time, large foreign reserve assets made Poland a financially self-sufficient country, which meant that the government was not in

[396] In a way, the entire discussion on 'additional safeguard' stemmed from the Fund's fundamental (but not openly articulated) lack of faith in the Polish reform.

urgent need for completing the current stand-by with the IMF. The latter was aware of this fact. In late October, Guitan wrote to Camdessus that given the build-up of reserves, an interruption of purchases would not be problematic for the Polish government as far as the availability of foreign exchange was concerned. He immediately added, though, that it would block the release of the second tranche of the structural adjustment loan (SAL) from the World Bank, and, more importantly, it could slow the progress on the discussion over debt reduction being made with the Paris Club.[397] Interestingly, he remarked that the government would have to continue tight financial policies either way – if not at that time, then at the outset of the next program with the Fund.

In the fourth quarter of 1990, in correspondence of the Fund experts there were several more references to both issues, namely, the financial consequences of terminating the agreement and the possible ways for redirecting the Polish government from the wrong path to the reformatory one. In November, Guitian repeated that the short-term consequences of terminating the current agreement would be the suspension of the release of the second tranche under the World Bank's SAL and the inability of the government to draw on the Stabilization Fund, whereas in the long run, "discussions with the creditors on debt reduction would not be helped."[398]

Eventually, in December, Russo informed Camdessus that Poland violated several performance criteria set for the fourth quarter. He proposed that waivers be suspended so that the government could not draw on the fourth and the final credit tranches under the SBA. For January, he planned that one of two options was acceptable: either the current program would be aborted if negotiations on the Extended Fund Facility proved successful or the current program would be extended by a few months.[399] What is characteristic, Russo foresaw to inform Balcerowicz "of these decisions", which suggests that he had no intent to discuss them with Poland. However, the most important was the justification given by Russo for the option of extending the current agreement: it would facilitate debt reduction by private and official creditors and further drawings on Stabilization Fund and SAL [400]. That is, the second option meant that the current program was extended and chances for reduction were preserved, yet in a longer term.

[397] IMF Archives, Poland, Correspondence and Memos, Oct.1990, File 3, *Poland – back-to-office-report*, October 24, 1990.
[398] IMF Archives, Poland, Correspondence and Memos, Nov-Dec 1990, File 4, *Poland - Briefing Paper*, November 6, 1990.
[399] IMF Archives [...] *Poland*, M. Russo to the MD, December 14, 1990.
[400] Ibid.

As can be seen, in December 1990, the IMF mission did not take into consideration any longer that the current SBA be completed as originally scheduled. Meanwhile, Poland decided to complete it exactly at that time, i.e. March 1991. This may be surprising, since in line with Russo's memo, a timely completion of SBA by the government was not a condition for concluding another program. Moreover, the option of extending the current SBA program also gave Poland the chance for gaining financial assistance from the West, including debt reduction. Hence, if despite this fact the government wanted to complete the SBA program as scheduled, it meant that it needed to obtain waivers to be granted debt reduction rather sooner than later. Furthermore, a timely completion of the SBA program would give a prospect of concluding the Extended Fund Facility program immediately after the first program was completed. This would result in a great pressure on creditors for granting debt reduction to Poland, without which the program would have no chance to be implemented. Poland also remembered that the Paris Club made holding the Working Group meetings conditioned on the implementation of the stand-by program, and the meeting of the group in October put the debt reduction issue on a far better course than the one held in June.

The fact that the Polish government was focused on completing the current SBA program to keep the prospect of quick debt reduction can be proved by a government note of February 1991 on the current cooperation with the IMF. The note states that an agreement with the IMF on a letter of intent on the government's economic policy in the first quarter of 1991 [emphases added] "would serve as evidence of the agreement with the IMF being continued as part of the adjustment program and would create a situation of a <u>natural</u> end of the 'stand-by' agreement by replacing it with a new agreement (EFF from April of this year). Hence, it would not be considered as an abortion of implementation of the 'stand-by' agreement by unfulfilling implementation measures that were formerly agreed on, <u>which can be significant due to the conducted negotiations with creditors on debt reduction</u>. This situation would facilitate continuation of the agreement on the Stabilization Fund and strengthen our negotiation position with the creditors."[401]

Therefore, the government aimed at keeping reduction a priority in current negotiations with the Club. In order to "naturally" close the current agreement, 'waivers' had to be received. To

[401] *Notatka rządowa o stanie współpracy z MFW [A government note on the current cooperation with the IMF]*, February 6, 1991. Archives of the Ministry of Finance, Poland-IMF Cooperation, A/822/27 (February 6, 1991-December 15, 1991, 167 pages).

this end, the authorities raised nominal interest rate in three stages: from 35 percent to 44 percent in October, then to 55 percent in November and to 72 percent in January 1991.[402]

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The above-described turn in the Polish government's economic policy was the first case from the launch of the reform where the debt reduction prospect decided on the reform to be continued under the agreements made with the IMF. According to this, in the further part of the thesis I argue that after 1991 it was debt reduction that became the major factor that accelerated the implementation of the rapid transition reform. The role of debt reduction as the main stimulus to continue the reform was all the more understandable as in the conditions of increasing overall adjustment fatigue finding any stimulator of tough adjustment policies was very difficult. In this sense, Poland's case is unique among the post-socialistic countries undergoing transformation. I try to prove that in 1990-1994, the debt reduction prospect decided as many as three times on the abandonment of macroeconomic easing chosen for domestic considerations and on the return to the path of stabilization-cum systemic reform anticipated by Western creditor institutions.

The first 'step backwards' from the reform agreed on in 1989 took place in the summer of 1990. The second instance of relaxation of macroeconomic policies occurred only several weeks after the successful signing of the debt reduction agreement with the Paris Club. In May 1991, Poland suddenly and unilaterally moved away from the policy direction agreed under the EFF, which had a more profound effect on relations with the IMF than any other factor in the subsequent years of their cooperation. In fact, the decision taken by the Polish government[403] meant a return to soft macroeconomic policy of the third quarter of 1990: that time, 'relaxation' stemmed from adjustment fatigue and the need to let Polish society 'breethe'. The fact that in April 1991 Poland moved away from the economic policy set up with the IMF in such a rapid way proved that the need for a 'breath' after a 9-month radical shock stabilization operation (from October 1989) was still the preferred direction in the government's economic policy. In this view, one can see even better that the corrective actions in interest rates performed at the turn of 1991 were motivated primarily by a willingness to obtain debt reduction quickly.

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[402] *Calendar of the implementation of the economic program in 1989-1991*. „Polish Transformation, Documents and Analyses 1991-1993", pp. 426-427.

[403] In January-December 1991, the second 'Solidarity' government was in power in Poland. Since it was headed by Jan Krzysztof Bielecki, a member of a party promoting economic liberalism, while Leszek Balcerowicz remained the Minister of Finance, cooperation between the government and the IMF was going well.

Likewise, the obligation the government undertook in March 1991 to meet objectives of the new three-year EFF program was driven by its willingness to receive debt reduction. This was depicted in a conversation the author of this thesis had with one of the key negotiators of this agreement, Stanisław Gomułka, who said: “It was exceptionally important from the perspective of negotiations with Western governments that the three-year agreement with the IMF be made. In the spring of 1991 we realized that assumptions regarding economic growth, fiscal situation, etc., for 1991 were unrealistic and that most likely the new agreement with the IMF will break down quite soon. At that time, a question arose: should we renegotiate this agreement or should we rather say, ‘OK, let it break down.’ A decision was made to sign the negotiated EFF, while understanding that it will break down. Yet in the meantime, we will arrange the debt reduction agreement with the Paris Club and at a meeting with the Club the IMF will confirm it has concluded a new EFF agreement with Poland.”[404]

Here, it is worth noting that both these cases of the government’s return on the path towards implementation of the restrictive reform show that in fact, Poland ‘wrested’ debt reduction for itself. This took place in two stages. First, despite the tremendous political pressure in Poland to alleviate the reform, the government returned ‘for a while’ to restrictive financial policy at the turn of 1991 to maintain the opportunity for imminent debt reduction. In turn, several months later, it signed the EFF agreement knowing it could not be fulfiled, to receive the first tranche of debt reduction. Afterwards, it immediately returned to the relaxation of macroeconomic policies.

4. Economic implications of ‘adjustment fatigue’

Further in the thesis, I argue that in the years 1992-1994, a combination of two factors determined successful completion of Poland’s transformation reform launched in 1989. On the one hand, this was the awareness of Poland’s unilateral move away from the agreement with the IMF in May 1991, as a result of which both parties had to face the alternative: either the next program is fully implemented or the cooperation is terminated. The second key factor determining Poland’s economic policy and, at the same time, cooperation with the IMF, was the shrinking ‘window of opportunity’, i.e. the three-year period given by the Paris Club and the Fund to Poland in 1991 to implement the program if the second tranche of debt reduction

[404] Author’s conversation with S. Gomułka.

was to be granted in April 1994. The awareness of the EFF being terminated by the Polish government prompted both parties to develop an economic program that this time would be considered by the government as possible to fulfil. Hence, the future program had to be less restrictive than the EFF program but also had to meet the Fund's requirements, i.e. had to be compliant with the objectives and directions of the rapid transition to a free-market system set in 1989. I try to prove that the sole guarantee of both parties' interests to be reconciled was the willingness to receive debt reduction as originally scheduled.

Just as for Poland the most important objective was to complete the debt reduction process, for the Fund it was to complete cooperation with Poland in the form of the transformation reform launched in late 1989. The means used by the Fund to attain this goal was, first, Poland's pursuit of a *timely* debt reduction from both groups of creditors and, second, two 'slip-ups' of the government in 1991 and 1992, stemming from the government's excessive optimism in setting a fiscal target and its subsequent inability to reach it. In order not to allow the third case of overestimated revenues and underestimated expenditures, the Fund demanded the government to take into account a certain 'reserve' when setting the budget for the years 1992-1993, which accordingly tightened the fiscal adjustment operation in 1993.

However, before the government realized the 'window of opportunity' was shrinking, relations between Poland and the Fund experienced a state of limbo that continued from the spring of 1991 to the spring of 1992. In that period, the issue of further debt reduction was 'suspended' or, to put it differently, was no longer considered a priority by the government. Once it obtained the permanent reduction of the 30 percent of the official debt, it could focus on more urgent matters. One of those was a very strong political pressure to implement mechanisms for stimulating economic activity. As a result, the government took adequate policy measures. While in mid-1990 only a loosening in the restrictive economic policy with the reluctant approval of the Fund took place, in the spring of 1991 the government without any consultation with the IMF changed the objectives of and the instruments for conducting economic policy. In practice, this meant a substantial reversal of policies agreed on with the Fund.

Only several days after the agreements with the IMF and the Paris Club on the first tranche of debt reduction were concluded, Mark Allen, the Fund representative in Poland, shared with Russo his "not very encouraging" impression of negotiations with government representatives who were working on the revision of the budget plan that had just been set with the IMF. Already at that time, Allen sensed that it was the revision the Fund would have little influence on.[405] One week later, he informed Russo that the government was discussing devaluation or lowering interest rates, and that ultimately, it was decided that the latter be reduced from 5.7 percent a month to 4.7 percent a month. Allen had an understanding approach to this move, stating that inflation in April was 2.7 percent, and was projected at the same rate for May. Thus, he argued, the interest rate would remain positive in real terms.[406]

Nonetheless, another week later, Allen wrote to Russo in a very pessimistic tone about the threat of an extremally incoherent program in Poland.[407] First, he informed about Balcerowicz's decision to devalue the zloty by 15 percent.[408] He then quoted a devastating opinion of Deputy Managing Director Richard Erb, according to whom those 15 percent would lose the government's credibility, while not giving any real benefits.[409] The very critical stance of the Fund stemmed from a concern that devaluation would be followed by price increases in light of the projected softening of fiscal and monetary policies by the Polish government.

The government's new monetary policy was very concerning to the IMF. Worse, as it soon turned out, changes in the economic policy were not limited solely to decreasing interest rates and altering the exchange rate regime. Developments continued to go wrong when Poland started moving away from the two key performance criteria specified under the EFF program, namely, the limit on the budget deficit and the floor for the net international reserves (NIR). The latter was a particular violation of the principle that was sacrosanct for both Paris Club and the IMF, that is, treating the balance-of-payments as a constraint. Below I present how significant were the issues of NIR and the budget deficit for the IMF and creditors, and – in a broader view – for completing the rapid transition reform in Poland. Soon, the prospect of receiving the second tranche of debt reduction became a major catalyst in bringing those two macro-economic parameters into line with the expectations of the international financial community.

[405] IMF Archives, Poland, Correspondence and Memos, March-April 1991, File 1. M. Allen to M. Russo. *Poland-Forthcoming Discussions*, April 23, 1991.
[406] IMF Archives, [...] M. Allen to M. Russo, *Poland - New Measures*, April 30, 1991.
[407] IMF Archives, Correspondence and Memos, May-June, File 2, *Poland-Policy Changes*, M. Allen to M. Russo, May 8, 1991.
[408] At the beginning of 1990, a fixed exchange rate was introduced as an anti-inflationary anchor. Initially, it was planned for 90 days, but due to high inflationary pressures it was extended over one year and a half. Even though its anti-inflationary aim was reached, this led to a loss of Poland's external competitiveness. Thus, on May 17, 1991 the exchange rate of the zloty was devalued by 16.8 percent. It was moved from 9,500 zloty to 11,000 zloty per dollar. Additionally, the peg was shifted to a five-currency basket.
[409] IMF Archives [...] *Poland-Policy Changes*, May 8, 1991.

1) Reserves

The issue of reserves was that important to the Paris Club and the IMF because it was the clearest measure of the government's capacity to keep external balance in the economy (that is, also its credibility). More precisely, an adequate level of reserves was considered a guarantee that the balance-of-payment constraint would be respected by the government. At the time, the Polish government was expected to stick to this fundamental principle in debtor-creditor relations, according to which internal imbalance could not be eliminated at the expense of external balance. The Fund and creditors saw in the government's broad and genuine recognition that balance-of-payments viability was inviolate the sole justification for continuing financial support, which in the case of Poland boiled down primarily to unprecedented debt reduction. The aim of this support was to allow the government to conduct a macroeconomic adjustment intended to bring long-term and sustainable payment capacity. Debt reduction was to consolidate the attainment of the historically unique stabilization-cum systemic reform and from the very beginning, for all engaged in the Polish reform, it was clear that without debt reduction, Poland would never gain external viability.

Meanwhile, as stressed in July 1991 by one of the members of the IMF mission, the Poles were not worried about the balance-of-payments, which they did not see as an effective constraint for the time being.[410] He drove attention to the fact that for the Polish authorities, political problems were far more urgent. The fact that external viability was not a priority of the government was evidenced by the scale of the reserves loss in 1991. By the end of that year, reserves shrank by 1.5 billion dollars as compared with an increase of 250 million dollars targeted under the program.[411] The principal factor responsible for this was a surge in imports, especially of consumer imports.[412] Below, I try to prove that in creditors' view, Poland in the second half od 1991 did not deserve further debt reduction.

Poland's payment capacity to the Paris Club after 1994 depended on a proper level of foreign reserve assets being maintained by the Polish government in 1991-1993. Hence, the Club treated the three-year period of the Extended Fund Facility as a 'window of opportunity' for the Polish government to rebuild in that time the reserves to a level sufficient for covering three-month imports. Smaller reserves would mean a residual financing gap that would have

[410] IMF Archives, Correspondence and Memos, July-September, File 3, *Poland--State of Affairs*, July 11, 1991.
[411] Ibid.
[412] IMF Archives [...] P. Hole to MD, *Poland - Review Under Extended Arrangement*, July 15, 1991.

to be closed again to postpone the risk of insolvency. Nonetheless I show below that initially, the Paris Club adopted the debt reduction option that did not ensure a proper reserves/imports ratio for Poland, which meant exactly the risk of insolvency of that country in the long term.

The IMF balance-of-payments scenario submitted to the Paris Club suggested a need for an over 50-percent debt reduction.[413] In March 1991, the Fund claimed that the 50-percent reduction option with 15-year annuity (since 1994) with *flat* payments adopted by the Club would create a sizable residual financing gap. In order to prevent reserve levels from dropping after 1994, the Fund made case for longer maturities and *graduated* payments schedule."[414] The Paris Club refused to extend maturities beyond 15 years, but accepted graduating repayments to bring them more into line with Poland's repayment capacity. After all, as the Fund argued, it was the creditors who ultimately were expected to ensure Poland's credibility in the longer term in their own interest. Owing to the Fund's intervention, the ultimate prospect of debt reduction envisaged that after 1994 payments would increase annually by 5.8 percent. That meant the repayments increasing substantially near the turn of the century, yet it was assumed that by that time, the Polish economy would be strong enough to meet increased obligations. According to the new debt reduction schedule, international reserves would amount to about the equivalent of 2.8 months of imports at the end of the decade, which was substantially higher than in the previous Paris Club scenario.[415] Thus, the Paris Club agreement also provided the Fund with financial assurances for Poland's medium term viability.

Since the debt reduction operation was focused on decreasing the debt service by 80 percent in 1991-1993, it formed an overfinancing of about 2.5 billion dollars in these years and a threat of creating residual financing gaps after 1993. Against the background of a rapid dissipation of such a front-loaded assistance provided by the Paris Club agreement, the Fund and the Paris Club made the issue of building up reserves in the second half of 1991 an imperative for Poland.[416] Here, creditors' views were the same as those of the IMF: extra reserves were formed as a result of an 80-percent high reduction of the debt service not for the purpose of being squandered on consumer import. This additional reserve was that important because it constituted a guarantee of mid-term external viability. According to official creditors, the debt reduction agreement de facto overfinanced Poland's actual financial needs

[413] IMF Archives, Correspondence and Memos, March-April 1991, *Poland - Paris Club*, P. Hole to MD, March 15, 1991.
[414] Ibid.
[415] IMF Archives [...] *Poland--Paris Club*, D. Burton to MD, April 24, 1991.
[416] IMF Archives [...] *Republic of Poland - 1991 Article IV Consultation*, April 25, 1991.

in 1991-1993, and thus the Polish authorities should handle reserves at that time with even greater care.[417]

Here, it is worth to explain why the second tranche of debt reduction was crucial for the rapid transition reform to succeed. During the negotiations in early 1991 it was officially accepted that reduction of the Polish debt to Western governments would allow Poland to regain its long-term payment capacity only if its scale is no less than 50 percent. Additionally, as a result of the Fund's intervention, it was agreed that from 1994, with the end of the period of 'lowered' payments to the Club of 1991-1993[418], they would be turned from flat to graduated payments, so that to adjust them to Poland's payment capacity that would gradually improve. Importantly, if Poland failed to obtain in 1994 the second tranche at the level of additional 20 percent of reduction, these payments would be even greater and the government would not be able to regulate them over the next years. In this sense, the very 30-percent reduction of 1991, even if permanent, solved only a short-term problem of Poland's insolvency. The benefits arising from it were to end in 1993 together with the end of the three-year period of interests reduced by 80 percent, whereas the problem of continuous financing gap would reappear.

2) Budget deficit

The IMF mission report of July 1991 pointed to the fact that the government was not sufficiently concerned about the balance-of-payment constraint, and that it was replaced by current political issues. At the time, strikes were an everyday element of life in Poland and the society grew increasingly reluctant of Balcerowicz as a symbol of the shock therapy. The IMF mission was most concerned about all these pressures on the government being reduced by pumping up the budget deficit.[419] Hole wrote to the Managing Director that one of the two principal macroeconomic concerns, next to the tensions in balance-of-payments, was that the budgetary revenues would remain overestimated.[420] For that very reason, he argued, there was a need for additional measures, without which the budget deficit would be larger and the balance-of-payments weaker. From then on, these two issues, i.e. the requirement of a

[417]IMF Archives [...] *Poland - Paris Club*, P. Hole to MD, March 15, 1991.

[418] In 1991-1993, Poland under the Paris Club Agreement of April 1991, was paying interest to the Club at only 20 percent (the 80-percent reduction meant annual payments of about 600-650 million dollars).

[419] IMF Archives, Correspondence and Memos, July-September, File 3, *Poland--State of Affairs*, July 11, 1991.

[420] IMF Archives, Correspondence and Memos, March-April 1991, *Poland - Paris Club*, P. Hole to MD, March 15, 1991.

realistic estimate of revenues and the need for additional fiscal measures to stave off further deepening of the budget deficit and external imbalance formed the grounds for fiscal discipline the Fund expected from Poland.

Where did the problem of deficit come from? It should be stressed that Tadeusz Mazowiecki's government made an incredibly deep fiscal adjustment at the scale of 10 percent of GDP from October 1989 to June 1990, when the budget surplus reached over 3 percent of GDP. Although this surplus fell to 1 percent of GDP in early 1991, the fiscal target set under the SBA program was reached. Nonetheless, one year later, Poland was in a deep public finance crisis. The main reason of the growing deficit lay in external shocks that hit the entire region of post-communist countries. The most dangerous one, according to the Fund, was the recession and dislocation in CMEA markets and its impact on the volume of Polish exports. As a result of these shocks, the situation of state enterprises deteriorated significantly. Due to decreased demand for Polish products the output collapsed, which triggered a fall in sales revenues and profits that used to constitute two-thirds of the budget income. This all translated into the growing budget deficit.

The above-mentioned concern of the Fund mission regarding the government's tendency to reduce political pressures via budget proved right. Financing of social benefits grew in 1991 to tremendous proportions. The father of a new generous social policy was the Minister of Labor Jacek Kuroń. His social sensitivity was shared by other 'doves' in the government such as Prime Minister Mazowiecki or, later, Michał Boni, Kuroń's successor. It was not supported by 'monetary hawks' like Balcerowicz, but they seemed to have understood the need to develop a social safety net. It is noteworthy that this attitude of the Polish reformers reflected their sense of pragmatism and flexibility, even though they have been usually categorized as dogmatic neoliberals.[421]

The new social policy turned out to be the most persistent side-effect of the 'softening' of shock therapy. It aimed at reducing unemployment by increasing a number of pensioners. What served this end was the introduction of early retirement age and easy criteria for

[421] This is confirmed by Saul Estrin, a member of the IMF team advising the Polish government in 1990. In an interview given in 2012, he juxtaposed the Polish and Russian 'shock therapies', stating, "In Russia [civil society] plays no role at all. In Poland, the first government seeking to carry out a transformation, based on strong domestic and international competition, dramatically reduced living standards and created massive unemployment. In Russia, this would not matter, whereas in Poland the government lost the election. The following governments were changing quickly and each of them wanted to relieve the material hardship of the people and devoted more attention to social issues, thus decelerating the pace of integration with the world economy". Kozłowski, P., *Grzegorz W. Kołodko i ćwierćwiecze transformacji* [*Grzegorz Kołodko and the Quarter Century of Transformation*], p. 1121.

granting pensions.[422] The scope of the new policy is best seen when comparing pensions to wages, national income and budget expenditures over three years. According to the original reform program from 1989, the pensions/wages ratio was to remain at 1988 level (57 percent) in the following years.[423] However, between 1989-1991 this ratio increased by respectively: 58, 64 and 75.5 percent. The number of pensions went up from 7.2 percent of GDP in 1989 to 12 percent in the first quarter of 1992.[424] In 1991, the government spent 100 trillion zloty - or one-third of all budget expenditures[425] - on three social funds. As a result, in 1992 the state budget had to support seven pensioners for every ten employed workers.[426] The rise in social benefits and real wages boosted consumption at the expense of investments. Social spending was financed by greater taxes imposed on state enterprises, resulting in lower profits of the latter, which were the main source of capital expenditures. Over time, new social policy resulted in enormous budget deficit and constituted a major impediment to economic growth.

In November 1991, Massimo Russo informed Camdessus about the scale of risk that loomed over the Polish economy if the government did not take any action to stabilize the budget. He warned that, assuming unchanged policies, the deficit would rise to some 13-14 percent of GDP in 1992 and the risks that Poland might revert to hyperinflation was non-negligible.[427] Worse, there was no visible determination in the government to bring this situation under control and resist calls for reflationary policies. However, despite loosened policy, the output remained very weak. Ultimately, one of the most tangible symptoms of moving away from the reform took the form of negative real interest rates of 10 percent at the end of the year.[428]

For the Fund, the case of budget deficit was a priority, as it remembered about the fiscal overestimation done by the government during negotiations regarding the EFF program. The budget for 1991 was based on an assumption that the GDP would actually rise by 4 percent, while in reality, it dropped by 10 percent.[429] Another 'remembered' aspect was the sudden and unilateral departure from the EFF agreement with the IMF due to principles of new

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[422] Conversation between T. Kowalik and S. Gomułka, "Polish Transformation. Documents and Analyses. 1990", p. 63.
[423] *Economic Program of the Government*, October 1989. "Polish Transformation. Documents... ,1968-1989", p. 672.
[424] The number of pensioners and unemployed on benefits increased by 4 million in 1989-1993.
[425] *Notatka dotycząca 'popiwku' i noweli budżetu [Note on the Popiwek and the budget amendment]*; "Polish Transformation. Documents...., 1991-1993", p. 574.
[426] Bjork, J., *The Uses of Conditionality: Poland and the IMF*, p. 108.
[427] IMF Archives, Poland, Correspondence and Memos, Oct-Dec.1991. Russo To The MD, *Poland--Report on Staff Visi*t, November 21, 1991.
[428] Ibid.
[429] Wernik A., *Opinia o projekcie ustawy budżetowej na rok 1992* [*Opinion on the draft budget for 1992*], „Polish Transformation, Documents....,1991-1993", p. 527.

quality adopted in the economic policy. The first tangible result of this move away from the EFF program was the fact that only three months after that agreement was concluded, Poland violated almost all performance criteria. In the course of subsequent months, the Fund mission, bearing in mind past mistakes, continuously disciplined Poland to reach consensus on a realistic plan for the future budget and, in a broader perspective, on setting a realistic economic program.

Already in May 1991, the Fund mission warned the government against increasing income from taxes on profits and sales in the budget plan and attempted to convince it to seek additional revenues somewhere else.[430] In July, the mission pointed to the likelihood that the budget deficit would be larger than projected and this would leave an imprint on the weaker balance-of-payments.[431] Over the following months, Poland still could not adhere to the Fund's remarks as a result of which the latter's frustration continued to grow.

However, the government did not remain passive. By the end of 1991, it took attempts to convince the mission to accept a greater budget deficit. In September, the Vice Minister of Finance tried to explain Allen in how pathetic situation the government was in terms of the budget and whether there were any chances for alleviating the budget criterion.[432] The answer provided by the representative of the Fund in Poland was negative. This could stem from flexibility with regard to Poland proved by the Fund. Soon after the sudden termination of the agreement with the IMF in May 1991, the Fund agreed to substantially increase the fiscal ceiling at the end of the year from a 0.5 percent GDP deficit originally required under the EFF to a 3.5 percent GDP deficit. Moreover, being aware that the main challenge in the short run was to stop the deficit from further growing, the Fund agreed to decrease the floor for NIR from 500 million dollars to 250 million dollars at the end of the year.

Nonetheless, Poland was unable to extricate from a state of limbo and conclude a new agreement with the Fund. However, both parties concluded a new informal one that proved how big an impact the memory of the substantial relaxation of May 1991 had on both of them. In September, the Managing Director proposed a compromise, according to which the IMF would not undertake cooperation until it received a proof that the government was implementing the set fiscal target. Although the state of limbo continued, the cooperation was

[430] IMF Archives, Correspondence and Memos, May-June 1991, *Letter from M. Allen to L. Balcerowicz,* May 2, 1991.
[431] IMF Archives, Correspondence and Memos, March- April 1991 File 1, *Poland - Paris Club*, P. Hole to MD, March 15, 1991.
[432] IMF Archives, Correspondence and Memos, Oct-Dec 1991, *Poland-Forthcoming mission*, October 24, 1991.

not terminated and the EFF program was to be activated once both parties reached an agreement on the budget issue. In the fourth quarter of 1991, Mark Allen, keeping in memory the abandonment of the program of May 1991, drew attention of the Vice Minister of Finance Stefan Kawalec on how bad it would be for Poland's image at the Fund if it were to go to the Board now and again miss the end-September performance criteria.[433] Kawalec admitted that it was unlikely that the government would wish to proceed with the current letter if they knew they could not meet the performance criteria.[434] Hence, he suggested that Poland would not stand the Fund up again and would not try to force an agreement through. If it turned out that soon after an agreement was concluded the government would violate it, the latter would have to take into account that the cooperation would end.[435] For that very reason, at the time of the first review under EFF[436], the Polish authorities decided not to go ahead with the letter of intent.[437]

Obviously, the above compromise was a short-term solution. The deficit aggravated, and both the Fund and the Paris Club were running out of patience. Most importantly, however, the longer Poland did not want to take an anti-deficit action, the more the 'window of opportunity' for obtaining second tranche of debt reduction shrank. This disappearing prospect for debt reduction proved - as I try to show below - the key factor that motivated the government to action.

In line with the above, from 1992, the Fund and the Paris Club were to discipline the government more effectively. The Fund would remind it about the necessity to take anti-deficit actions aimed against the growing inflationary pressures, while the Paris Club would recall it should keep reserves at a proper level. Hence, the IMF and the creditors would still keep an eye on how the macrostabilization of the Polish economy was continued. An additional stimulus to decide on the reform to be decisively accelerated was the progressing aggravation of macroeconomic indicators. The deficit and the reserves, as the key criteria of economic policy, were in 1991 on the slippery slope and the authorities themselves were aware of the necessity to stop these processes. However, it was primarily the willingness to obtain the second tranche of debt reduction that became the factor that made them return on

[433] IMF Archives, Correspondence and Memos, July-Sept 1991. M. Allen to P. Hole, *Meeting with Messrs. Misiąg and Kawalec*, September 10, 1991.
[434] IMF Archives [...] *Poland - Discussions on the Program*, September 12, 1991.
[435] Author's conversation with S. Gomułka.
[436] The EFF agreement was still in force. Neither the Fund nor the government wanted to terminate it.
[437] IMF Archives,Correspondence and Memos, July-Sept 1991, *Poland*, M.Russo to the MD, September 17, 1991.

the path of the reform soon enough to meet the deadline for granting full debt reduction set in the spring of 1991 by Western governments.

Chapter VI. Uncertain paths of 'the March consensus'

Over the only five-month long mandate, Jan Olszewski's government[438] did not consider economic matters as a priority. The very brief tenure of that government was determined by a vetting action aiming at excluding representatives of the former system from public life. In early June 1992, the government produced a list of people who supposedly were agents of the former communist secret police and now occupied high positions within the state apparatus. The list included the name of President Wałęsa. As a result, the government was dismissed by *Sejm* with immediate effect. Although that government continued market-related reforms, it was openly critical of both Balcerowicz's policy and the IMF.[439] The only important achievement of this government in the area of economic policy that is usually listed was the approval by *Sejm* of the government's budget project that provided for a deficit of 5 percent of GDP in 1992.[440] Contrary to the above, I argue that the key achievement of that government in the area of economic policy, specifically foreign economic relations, was the establishment in March 1992 of a consensus with the IMF on continuance of the reform. Setting the deficit at 5 percent of GDP was only one of its elements. When the government collapsed, the budget deficit substantially increased, while the consensus was preserved in its fundamental form and was binding in the period of tenure of the two following governments.

The first pillar of this informal consensus was the 'memory' of the government's sudden and unilateral abandonment of the policy agreed on with the IMF. This memory made both parties agree to reestablish cooperation only when the government would be well prepared for it. The second pillar of the consensus consisted in the both parties agreeing that the granting of the second tranche of debt reduction as scheduled should depend on the implementation of further restrictive reform aiming at reducing budget deficit to 5 percent of GDP, keeping reserves at the level that would ensure mid-term solvency and acceleration of structural reforms. For the Fund, it was important that the transformation reform understood as a macroeconomic

[438] The third post-Solidarity government since 1989.

[439] One should note a certain paradox. From the very beginning, Olszewski's government oficially distanced from the previous shape of the reform, particularly the macroeconomic stabilization operation, and used Balcerowicz's name as a symbol of the economic policy that should be stopped once and for all. However, the factor that determined the government's continuance of this very policy was actions taken by the Minister of Finance of that government, Andrzej Olechowski, who was a kind of a 'mediator' between the old guard of the reformers and the IMF. Olechowski, however, did not fit in the new government due to its communist past and, as Prime Minister Olszewski suggested, was assigned as the Minister as a result of the pressure put on his government by the international financial community [interview with Prime Minister Olszewski, *Między PRL-em a niepodległą Polską*].

[440]Interview with Jan Olszewski. *Do Rzeczy*, June 4, 2017.

adjustment-cum-systemic reform was completed, while Poland gave precedence to the completion of the official debt reduction process. Both parties wanted to reach these objectives within the originally set timeframe, i.e. by April 1994. The consensus lay in making the second objective conditioned on attainment of the first one.

At first sight, it may seem that the consensus did not change much in the trilateral relations among the government, the IMF and the Paris Club. After all, the latter made granting of the second tranche conditioned on the continuance of the reform already in early 1991. However, I intend to show that in the face of such a drastic deterioration of the economic and political situation in Poland in 1991, the Fund concluded that it was impossible for Poland to get debt reduction within the original timeframe and assumed that the entire reform would be stretched in time. Then, in order to maintain the reduction deadline, Poland decided to accelerate the reform.

A visit paid by the Minister of Finance Andrzej Olechowski at the headquarters of the IMF in Washington in March 1992 was a breakthrough in the government's economic strategy. Olechowski learned from Camdessus and Russo that the Fund planned a new reform program that was to replace the current one and that it would mean redefining of the 'trigger clause' (i.e., the moment when the second tranche became effective). This meant that the Fund applied a measure very similar to that used in late 1990. At that time, it informed the Polish government that the stand-by program would be cancelled in the previously set form, to which the government replied by taking restrictive adjustment actions to keep the opportunity for quick debt reduction. Likewise, in March 1992, Olechowski argued that the 'trigger clause' of debt reduction had to remain as agreed on in March 1991 and, hence, wanted the current EFF program to be left as it was. Although eventually the program was cancelled, the Fund agreed to keep the term of the full debt reduction as originally agreed. Nonetheless, the government had to fulfil the following objectives: 1) to reduce the deficit to 5 percent of GDP; 2) to reach this target by means of structural changes (in place of the current manipulation of expenditures and revenues); and 3) to reach the level of foreign reserve assets of the amount of three and a half months' import.

Hence, in 1992, as at the turn of 1991, the government took over the initiative in cooperation with the IMF, forcing it to change plans and returned on the path of restrictive reform to save the closer term of debt reduction. In the months that followed the establishment of the consensus, as a result of the aggravating deficit, the Fund specified the shape of the fiscal adjustment required from the government. Since the government could not stand the Fund up again, as it would entail the risk of terminated cooperation, and it had to reach the above-mentioned objectives of the reform by the end of 1993, together with the Fund mission it developed the exceptional fiscal adjustment as it provided for a certain 'reserve'.

To avoid another 'failure', the government had to take additional security measures to ensure the deficit target is reached not in, say, 80-90 percent, but fully, which was stressed by the mission already at the end of 1991. This meant a stricter fiscal discipline compared to the one potentially introduced by the government without the pressure in the form of both factors, i.e. 'memory' and debt reduction as scheduled. Importantly, in the period of 'window of opportunity', when the government was to show its best to Western creditors, in Poland, specifically after 1992, strikes and other forms of social discontentment took place again and again. Since strikes stemmed from the economic policy pursued from the end of 1989, the government's return on the restrictive path of the reform was in these conditions highly hindered. Adjustment fatigue was a common phenomenon in other countries undergoing IMF-supervised anti-inflationary programs, yet in Poland, it could be and actually was overcome only due to the ongoing prospect for receiving full debt reduction.

Thus, from the end of 1992, Polish economic policy was determined by a combination of two factors. On the one hand, it was influenced by the 'memory' of the government's sudden abandonment of the EFF agreement and of the excessive fiscal optimism in budget projecting. Due to the 'memory', the Fund was exceptionally susceptible to any further government derogations from the joint agreement and thus demanded additional precautionary fiscal measures.[441] On the other hand, the willingness to complete the debt reduction process as scheduled mobilized Poland to swiftly compensate for the year-and-a-half losses in the reform implementation.

1. The conclusion of the 'March consensus'

Due to the new economic strategy adopted by Olszewski's government, already during the first conversations with representatives of the Ministry of Finance, the Fund mission resorted to the argument that the official creditors' opinion on debt reduction stemmed from the government's determination to implement the economic program agreed on with the IMF.

[441] The final level of the 5 percent deficit was considered by both the Fund and Poland a manifestation of the former's high flexibility.

The fact that it was the key argument warning the Polish government against the consequences of moving away from the anti-inflationary policy was evidenced by Allen's report from a conversation with two main decision makers in the government on economic matters. In response to the Prime Minister's statement of the need for "renegotiation of the agreement with the IMF", Allen declared that in a situation where the new government failed to sign the Memorandum of April 1991, the Fund would have to consider a new agreement.[442] Most importantly, Allen informed the two members of the government that "Poland had every right to take this path, but it might cause problems with the creditors."[443] Two days later, after a conversation with Prime Minister Olszewski, Allen confirmed the lack of vital determination to implement the reform further. Despite the Prime Minister's assurance that the government appreciated the assistance of the Fund and the World Bank, Allen got an impression that the Prime Minister was not eager to conclude an agreement with the IMF.[444] His feeling that the cooperation with the IMF was not a priority to the government proved right in bilateral negotiations that took place later on.

After the initial negotiations, the IMF had no reason to assume that the new Polish government would continue not even the very EFF program but economic policy that was more or less compliant with the provisions of the program in question. For that very reason, already in January, the management of the Fund was considering how to continue cooperation with Poland. Below, I present the IMF internal discussion on the possible solution to the stalemate in negotiations with the Polish government. This solution, as I have already mentioned, had a similar form to that of the attempt to solve the stalemate with Poland at the turn of 1991.

For the first time, a suggestion to replace a still binding Extended Fund Facility with a new program emerged from the initiative of Jack Boorman, Head of the ETR Department. As a prerequisite for establishing any agreement, he specified formulation by the authorities of a coherent economic strategy. Assuming that this was to take place, Boorman presented an alternative: either to revive the EFF or to switch to a new arrangement. Importantly, the only consequence of the adoption of the second solution that he mentioned was the fact that „the Paris Club-debt reduction agreement would be a complicating factor."[445] Soon, it turned out

[442] IMF Archives, Poland, Correspondence and Memos, January-March 1992, *Meetings with Ministers*, M. Allen to M. Deppler, January 8, 1992.
[443]Ibid.
[444] IMF Archives [...] M. Allen to M. Deppler, *Meeting with Premier Olszewski*, January 10, 1992.
[445] IMF Archives [...] *Poland-Briefing for Staff Visit,* 31 January 1992.

that he referred to the necessity to renegotiate the agreement on the second tranche of debt reduction.

In mid-March, before the imminent visit of the Polish Minister of Finance in Washington, the Fund developed the above general concept into a detailed strategy towards Poland. It envisaged that the IMF would agree on a budget deficit of 65 trillion złoty (5.7 percent of GDP) instead the one agreed in 1991, that is, 45 trillion złoty (3.5 percent of GDP). The IMF stressed that "it is difficult to be enthusiastic about this budget" and that it sought compromise.[446] This attitude was surely due to the drastic estimate of the underlying deficit which, without special measures, was estimated at 16.8 percent of GDP.[447] It was the greatest scale of deficit that threatened Poland estimated by the IMF.

Obviously, the Fund set a series of conditions to be met if it was to approve of the deficit at 5.7 percent of GDP. First of all, this budget was to be implemented under a different agreement than the current one. The main justification for the termination of the present EFF was that the economy at the time was far off the originally envisaged track in a number of areas (budget, inflation, output, savings and investment, and the external position) and, on this budget, it seemed unlikely to get back on track within the time span of the EFF arrangement.[448] This meant that keeping the current program required either a longer timeframe or a decisively larger scale of budget adjustment. The Fund viewed the existing EFF arrangement as unrecoverable and concluded that it should be terminated.[449]

As the main disadvantage associated with the abandonment of the present EFF, Russo and Boorman specified the change in arrangements on the official debt reduction, according to which the second stage of debt reduction was contingent on the Fund's having completed by December 31, 1993 the last review of the arrangement under the EFF. Even though they admitted that any change of these arrangements would undoubtedly create difficulties, they "saw no alternative to asking that the trigger clause be redefined to refer either to a new EFF or one or more stand-by arrangements."[450] The fact that the IMF indeed excluded the possibility of a 50-percent reduction in the original term was evidenced by the annotation "I agree" made by Richard Erb, Deputy Managing Director, by the words, "We see no alternative..." on the photocopy of the document. It should be emphasized that despite the new

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[446] IMF Archives [...] J. Boorman and M. Russo to the MD, *Poland-Visit of Minister Olechowski*, March 13 1992.
[447] Ibid.
[448] Ibid.
[449] Ibid.
[450] Ibid.

strategy towards Poland being agreed on by the most influential individuals in the Fund, it was soon changed in the most important aspect that pertained to the term of debt reduction, as a result of a Polish ‘intervention’. This proves that debt reduction was a matter of priority to the government.

For the first time, this stubbornness and decisiveness was manifested by Minister Olechowski during his visit at the headquarters of the IMF in Washington in mid-March 1992. In a conversation with Camdessus and Michael Deppler[451], Olechowski said that the government’s “biggest problem concerned external financing and the Paris Club agreement, and in this context it was their desire to return to the original EFF arrangement with the Fund that would secure significant Fund resources before the end of the year and would also assure the Paris Club debt reduction as scheduled.”[452] This clearly suggests that one of the two key arguments for keeping the existing arrangement with the Fund was the guarantee of the original term of further official debt reduction being observed. The other argument was the external financing, which I address further in the thesis.

One should note the dynamics of the conversation between Polish delegates and the management of the Fund described in a memo by Liam Ebrill from the Fund’s European Department, who was present at the meeting. At the beginning of the meeting, the Managing Director expressed his doubts about the feasibility of returning to the old arrangement. Then, Olechowski emphasized “that the most important advantage of returning to the old EFF is that the Paris Club debt reduction would not then be interrupted.”[453] Seeing Poland’s determination, Camdessus stated at the end of the meeting that he saw a possibility for a return to the old EFF, yet under specific requirements. He said that Poland must be successful on the fronts of reducing budget deficit, pursuing structural policies and rebuilding reserves.[454] Obviously, the vital prerequisite for the above consensus to work was that the government maintained adequate macrofinancial policies. Below, I describe the key elements of this consensus.

[451] In 1991, Michael Deppler was appointed Deputy Director of the European Department and became a new chief of the IMF staff missions in Poland.
[452] IMF Archives [...] *Meeting of Finance Minister Olechowski with the Managing Director*, March 25, 1992.
[453] Ibid.
[454] Ibid.

2. The elements of the ‘consensus’

1) Inviolable deficit target

Lowering the deficit to 65 trillion złoty (5.7 percent of the GDP) was a priority for the Fund, which was confirmed at the meeting in March by Camdessus, who said that “the number had acquired symbolic significance.” Although the new program was planned for a 20-month period, its main part would be a fiscal adjustment in 1993. In turn, for the second half of 1992, a serious fiscal action was planned, which was sort of a “quasi holding operation”[455]. It was designed “to preserve the financial stability”[456] through reducing the deficit adequately. Thus, the ground would be prepared for a more decisive adjustment in 1993 that would support the economic recovery.

Hence, the budget policy had a similar objective to that from the end of 1989: to stabilize the drastically aggravating macroeconomic situation and, thereby, lay the basis for a more significant action as of the beginning of the new year. The link of negotiations on the budget and the economic program for 1992 with the budget of 1993 was a sign that the Fund expected Poland to return to the reform launched in 1989 both with regard to the scale and the pace of adjustment, and the authorities’ determination. The budget situation was here a case in point. The IMF remembered how in 1991 the deficit aggravated, creating an underlying deficit in the following year. With the intention to prevent those mistakes from happening once again and to provide a good starting point for the budget in 1993, the Fund demanded in 1992 “firm commitments for 1993” from the government and introduction of a realistic set of measures to contain aggravation in the last half of this year.[457]

[455] IMF Archives [...] M. Allen to M. Russo, *Poland - Conversation with Nigel Wicks*, March 25 1992.
[456] *Concluding Statement of Mission*, Warsaw, May 12, 1992. „Polish Transformation. Documents..., 1991-1993”, p. 545.
[457] IMF Archives, Correspondence and Memos, April-September 1992, *Meeting with Minister Osiatynski*, M. Allen to M. Deppler, July 22, 1992.

2) Front-loaded structural measures

The drastically aggravating budget situation made a greatest weakness of the economic policy pursued from the end of 1989 clearly vivid. The weakness was the lack of institutional reforms. In this particular case, this did not apply to slippages in privatization or in reforming the banking system, but most of all, to the lack of an institutional barrier against expenditure and revenue manipulation for political reasons. From then on, the Fund found evidence for the macroeconomic situation being appropriately addressed in the form of the acceleration of efforts in the structural reform. In line with the principle that the Fund followed in cooperation with other countries, the longer a government was hesitant about establishing a structural adjustment, the more restrictive the reform in the future. Hence, in negotiations with Poland, the Fund put the greatest emphasis on the aspect of the pace of the future structural reform. It expected that the government would front-load the structural measures *to a greater extent* than had been originally intended.[458]

Addressing the deficit problem using a structural approach entailed developing such a balanced package of fiscal measures that would be “a very positive contribution to Poland's prospects”, as opposed to “a negative exercise in raising taxes and cutting expenditures.”[459] In his conversation with Prime Minister Olszewski in January 1992, Allen stressed that prior to any agreement, the Fund needed to have firm assurances that financial stability be preserved, and as a means to this end, revenue-expenditure solutions be strengthened so that they were not used by politicians ad hoc, as was the case at the time.[460] On other occasions in 1992, the IMF staff emphasized the need for a fundamental action on the fiscal situation to eliminate negative fiscal exercises[461] and selective and discretionary approaches regarding privatization, subsidies, credit, credit guarantees, tax relief, etc. All ad hoc measures of this sort resulted in financial abuse and wasted resources. The Fund claimed that the need for support for state enterprises, which was strongly stressed by the government, should be pursued with regard to budgetary constraints.

[458] This demand appears repeatedly in the IMF documents on the cooperation with Poland in 1992.
[459] IMF Archives[...], *Final Statement of IMF Mission Warsaw*, September 8, 1992.
[460] IMF Archives, Poland, Correspondence and Memos, January-March 1992, *Points for meeting with Prime Minister*, M. Allen to M. Deppler, January 9, 1992.
[461] *Concluding Statement of Mission in Warsaw*, 12.02.1992. Polish Transformation. Documents..., 1991-1993; p. 459.

The most urgent objective of the structural reform in 1992 was to ensure a medium-term improvement in public finances.[462] It aimed to improve the public finances on a lasting basis. The Fund mission clearly specified the path to reach this goal: it demanded new composition of revenues and expenditures through broadening the tax base, improving expenditure management and controls, and reforming social insurance programs.[463] As I show below, all these reforms were introduced in 1993.

3) Reserves path

The third condition for preserving the EFF listed by Camdessus in his conversation with Olechowski was the issue of reserves, to which, as Michael Deppler noted, the Paris Club attached considerable importance. The staff mission also emphasized the importance of this issue. In a memo to the Managing Director, Deppler wrote about issues worth addressing at the meeting with the Polish Minister of Finance on the next day. The aim was to sound the government out whether it was able to keep the deficit down to 65 trillion zloty and what kind of measures (including standby measures) it envisaged to finance the deficit. Most importantly, Deppler admitted that the easiest solution to finance the deficit in the short run would be to run down reserves. He then immediately added that this would ignore that those reserves were needed to get through a hump in external interest payments in the mid-1990s.[464]

At the same time, Camdessus tried to persuade Olechowski to abandon the existing EFF. He claimed that one should not be theological on the precise form of the arrangement. He ensured the Poles that the objective was rather to ensure the two outcomes of satisfying the Paris Club (adequate reserve path) and securing the economic adjustment that was needed.[465] It was the real actions aimed at keeping the reserves at the proper level that were to convince the creditors of the government's credibility and not that or another name of an IMF program.

In March 1993, at a GATT meeting on the case of Poland, a representative of the Fund explained the considerable increase in the reserves by 1.5 billion dollars in 1992 by three factors: the opening of the European Community market, liberalization of trade and payments

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[462] IMF Archives [...] M. Allen to M. Deppler, *Meetings with Ministers*, January 8, 1992.
[463] *Concluding Statement of Mission in Warsaw...*
[464] IMF Archives [...] *Poland--Visit of Minister Olechowski*, March 16, 1992.
[465] IMF Archives [...] *Meeting of Finance Minister Olechowski with the Managing Director*, March 25, 1992.

regime and the 1991 Paris Club debt service reduction agreement.[466] When referring to the first two factors, one should note that Western Europe was in recession at the time, while Polish export was heavily compromised by a draught of the century. This would indicate that the third factor, namely, substantial cash flow relief provided by the debt reduction, was of fundamental importance. The reserves 'saved' as a result of debt reduction operation could not be used for financing the budget. They were needed for a completely different purpose: to be used to enhance Poland's mid- and long-term payment capacity.

The 'March consensus' was that significant because it meant that from then on, Poland obliged itself to treat the combination of tight fiscal and external adjustments as permanent, aware of the fact that it was a condition for receiving the second tranche of debt reduction. Thus, the 'consensus' became a safeguard of the principle of balance-of-payments constraint. Otherwise, the government would most probably reduce the budget gap with foreign exchange reserves. At that time, however, it did not want to do so, since reserves were sacrosanct for the Paris Club. Below I try to show that the more dramatic the deficit financing issue looked, the more urgent was to find other sources of financing for the very purpose not to draw down the reserves.

3. Trilateral endorsement of the 'consensus'

Originally, the Fund's arrangements provided for the EFF being replaced with a new program along with a change in the date of the trigger clause of the second tranche of debt reduction. However, the visit paid by the Polish Minister of Finance made the Fund realize that the issue of receiving debt reduction as soon as possible was a priority for the government. The pressure it exerted made the Fund keep the plan for obtaining further reduction as scheduled, that is, in April 1994. However, one week after the conversation between Olechowski and Camdessus, Sir Nigel Wicks, a senior British Treasury official, informed Mark Allen that a stand-by arrangement would be the best course given the size of deviations from the EFF program.[467] Allen agreed adding that in such a case some understandings would have to be

[466] IMF Archives, Poland 1993, *Poland Statement by the Fund Staff Representative to the GATT Balance of Payments Committee*, March 15, 1993.
[467] IMF Archives, Poland, Correspondence and Memos, January-March 1992, *Poland - Conversation with Nigel Wicks*, M. Allen to M. Russo, March 25, 1992.

reached on how to trigger the second tranche of the Paris Club debt reduction[468] and, subsequently, how to make resources available for a Brady deal with the private banks. Wicks saw no obstacles to proceeding in this way.

Russo started his letter from early May to Vice President of the Paris Club by ensuring Western governments that the program currently negotiated with Poland would meet their expectations. He claimed that the new program would involve a sufficiently strong domestic adjustment effort to ensure an improvement in Poland's payment's capacity by 1994 which would enable Poland to start making payments under the agreed schedule. However, he added that this would be possible only if the second stage of the official debt reduction took place. He also expressed the Fund's view that "the timing of the final stage of debt reduction remains appropriate."[469] Hence, the consensus was almost approved: the Fund and the Club agreed that the original term of debt reduction be maintained, yet under a new program. The only thing lacking was the approval granted by Poland.

The final attempt of the Polish government to convince the Fund to activate the EFF left no doubt as to whether further debt reduction was a priority for Poland. Olechowski's stubbornness surprised Deppler, who, generally speaking, tried to convince him that the matter of foreign debt was to serve the reform and not the other way round. He started his report for the Managing Director from the telephone conversation with Olechowski by stating that "The Minister is unconvinced about the need, desirability, or necessity of moving away from the present EFF" and that he planned to appeal directly to Camdessus the Fund's decision to opt for a 20-month SBA rather than maintaining the EFF.[470]

In response to Olechowski's stubbornness, Deppler first resorted again to the arguments that the continuance of the existing EFF implied undertaking "too draconian measures to be contemplated", and then added that it would in any case require rephasing within the EFF program, which in turn would lead to the Paris Club trigger clause being postponed. In short, the Fund did not believe that Poland was capable of completing the existing EFF and that it would be even counterproductive given the Poles' major goal was to accelerate debt reduction. Deppler even claimed that the Fund's approval for maintaining the EFF "would be tantamount to letting the Paris Club determine the Fund conditionality."[471] Therefore, he

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[468] Ibid.

[469] IMF Archives, Correspondence and Memos, April-September 1992, *Poland's Relations with the International Monetary Fund. Note prepared by Fund staff,* May 4, 1992.

[470] IMF Archives [...] *Poland – Call from Minister Olechowski,* Deppler to the MD, May 11, 1992.

[471] Ibid.

made a clear statement that seeking the reform to be subjected to the matter of receiving the second tranche of debt reduction as scheduled meant that the reform as such is of a secondary importance. And that was unacceptable to the Fund.

To prevent the above scenario, Olechowski was assured that the reduction issue could be solved as Poland intended also under the new SBA program and that the Paris Club would not hinder it. This part of the conversation sheds a better light on the reasons for Poland's stubborn attitude. Olechowski noted that the "EFF's are viewed by the international financial community as seals of approval and he does not wish to lose this imprimatur by shifting to an SBA."[472] Poland presumably received such first-hand information at negotiations with the head of the Paris Club and representatives of Western governments. Deppler remarked that these signs were completely different from those received by the Fund from the very same governments of the US, the UK, West Germany and France, which all agreed on the 20-month SBA.[473]

The fact that Western governments approved the new SBA program that was less restrictive than the EFF proved their flexibility towards Poland and a sense of responsibility for the reform they supported from the very beginning. In his conversation with Olechowski, Deppler stressed this aspect of cooperation with Western governments, telling him that apart from these four governments, other creditors might find this new SBA insufficient but could presumably change their mind.[474] Hence, the Paris Club expected the Polish government not that it would implement the reform under the old EFF but that the new program was restrictive enough to ensure that Poland regained payment capacity after 1994. This was also referred to as the main guarantee by the Fund in its above-mentioned letter of May to Vice President of the Paris Club.

It should be stressed that despite that misunderstanding over the Western governments' attitude towards Poland, the justification provided by the Polish Minister of Finance for the stubborn demand for the EFF option ("since that is expected by Western creditors") proved that in 1992, the matter of completing debt reduction in the original timeframe determined the nature of cooperation with the IMF and, consequently, the pace and scale of the economic reform.

[472] Ibid.
[473] Ibid.
[474] Ibid.

In June, in a conversation with John Robson, Deputy Secretary of the US Treasury, Olechowski informed him that the Fund was pushing a new SBA and the Polish government was ready to accept it “provided that they did not have to go through a series of hoops with the Paris Club.” Poland was then almost certain to opt for a change of IMF program, yet it wanted to avoid the troublesome procedure of reestablishing details of the debt reduction operation this entailed, or even a delay. Deppler’s assurance of May that this would not take place could be the decisive argument for the Polish government.

Eventually, there was the long-awaited opportunity for concluding an agreement with the IMF on the new economic program and for substantially increasing chances for obtaining the second tranche of debt reduction. However, on June 2, in the course of his last conversation with Olechowski, Allen noted that the Fund “needed to negotiate with a Government that could make credible commitments for the next eighteen months”[475] (i.e. by the end of 1993, when the Executive Board was expected to give a green light to the Paris Club on further debt reduction). This meant that in the light of a highly uncertain political position of Olszewski’s government, it was better to restrain for the time being from sending the staff team to Warsaw to discuss details of cooperation on the new program. In this context, Allen recalled that it would not be good for Poland to have another agreement that collapsed at the first hurdle[476], which was an allusion to the government’s sudden abandonment of provisions of the EFF agreement concluded with the IMF in April 1991. Thus, 3 days before Olszewski’s government was dismissed, in his conversation with Olechowski, Allen confirmed the existence of the consensus regarding further cooperation between Poland and the IMF.

4. Need for external financing

As I have mentioned above, the Minister of Finance Andrzej Olechowski in his conversation with the Managing Director in March 1992 specified two arguments for continuing the current EFF. Apart from keeping the original term of debt reduction, the other “biggest problem” was to secure external financing for the purpose of closing the deficit gap. Below I focus on how debt reduction (in the form of the actually granted reduction in 1991 and in its conditional

[475] IMF Archives [...], *Meeting with Minister Olechowski*, M.Allen to M. Deppler, June 2, 1992.
[476] Ibid.

form) affected the shape of the Polish economic policy in the years 1991-1993 by preventing numerous forms of external finanacing.

On the one hand, the need for external financing stemmed from the above-described scale of deteriorating budget situation in Poland in 1991. The urgent need for finding a way to finance the deficit arose when due to drastically bad budget situation, possibilities of raising revenues or cutting expenditures were exhausted.[477] On the other hand, the problem of external financing should be considered in the context of the transformation reform, more specifically, its baseline objective that determined the launch and success of the structural reform, i.e. decreased and stabilized inflation. The government knew that the Fund would approve and engage in seeking a way to finance the deficit only if it was non-inflationary.[478] Hence, the deficit should be financed by unconventional means to remain focused on the overarching objective of the reform, that is, curbing inflation.

Before I proceed to depict the joint attempts taken by Poland and the Fund to organize external financing on creditors' conditions, I present conventional ways for financing the deficit. I argue that these could not have been accepted by the Polish government due to the issue of debt reduction – the reduction already granted at the time and that conditioned on the restrictive reform being completed.

In October 1991, the Vice Minister of Finance Stefan Kawalec suggested that the debt service be financed by a drawing down of reserves of about 2 billion dollars, with the Government paying the National Bank in the form of long-term bonds.[479] Although I could not find the Fund's response to this proposal, it was most likely negative. This solution would result in the very same effect as rolling over debt using foreign credits. Though there would be a temporary relief, in the long run, when the time came to repay credits, this would have to be done in an inflationary way.

Another way to reduce the deficit was to use outstanding resources of the IMF as a consequence of restoring the implementation of the EFF program. This very form of external financing was suggested by Olechowski in his conversation with Camdessus as a justification for maintaining the existing EFF. For the government, keeping this program entailed not only securing the Paris Club debt reduction as scheduled, but also an access to significant and

[477] *Budżet państwa na rok 1992, wydatki bieżące sfery budżetowej* [*Draft budget 1992. Current expenditure in the budget sphere]*, 5.03.1992."Polish Transformation. Documents and Analyses 1991-1993", p. 493-495.
[478] IMF Archives, Correspondence and Memos, Oct-Dec 1991, *Poland-Forthcoming Mission*, October 24, 1991.
[479] Ibid.

undrawn Fund resources of some 1.5 billion dollars.[480] What is more, the government hoped to receive these resources soon, since the IMF approved of the current economic policy confirmed by the government's approval of the budget plan for 1992 required by the IMF.

However, Polish delegates were soon corrected to abandon this erroneous approach. According to Russo, these flows could not be run through the budget since they were borrowed from the Fund by the National Bank of Poland (NBP). Technically, the disbursements took the form of an increase in reserves with an adequate increase in the NBP's liabilities to the Fund. If the government decided to utilize these resources, it would have to be offset with an increase in bank credit to government. This in turn could either create inflationary pressure or jeopardize the fulfilment of the performance criterion of net credit of the banking system to the government.

Here, two remarks apply. Firstly, Olechowski treated the chance for receiving unused resources of the Fund as one of the two arguments, aside from keeping the prospect of debt reduction as scheduled, for maintaining the existing EFF. Although the Fund did not approve this way of financing the deficit, over the next weeks - as I proved above - the government still argued that the EFF be maintained. This stubbornness hence stemmed primarily from a willingness to receive the second tranche of debt reduction in the original timeframe. Secondly, both proposals for financing the deficit presented to the Fund by Kawalec and Olechowski provide ground for a belief that these types of measures for implementing budget policy would be chosen if the government could decide on it independently, i.e. without being pressured by Western creditors. Eventually, the government restrained from inflationary financing of the deficit due to the need for pursuing the rapid transition reform in a specified time to obtain full debt reduction.

Moreover, the most 'natural' way of financing the deficit gap was closed for the government, namely, taking new credits from Western governments. Credits from Western commercial banks were ruled out due to their interests in the Western debt relief strategy towards Poland being disregarded in 1989 when the reform was to be implemented. In turn, new official credits[481] would mean additional payments in the time when Poland was expected to pay old reduced and rescheduled loans. Moreover, in relation to Poland's uncertain debt service capacity there was one of major concerns of Western governments with Poland, namely the

[480] Despite the sudden departure from the terms of the EFF in 1991, the agreement was not terminated and Poland could theoretically use the IMF funds.
[481] Only mid-term credits could be considered, since the government in one of the perfomance criteria obliged itself not to enter into short-term commitments abroad.

matter whether Poland would ensure for itself a sufficient level of reserves to service foreign debt after 1993. This explained the need for them to continue credit restraint policy towards Poland.

Poland's stance was identical. In a Memorandum of December 1992, the government, in order to avoid burdening Poland's limited debt service capacity, ensured that official or officially guaranteed borrowing was prudent and limited to priority sectors.[482] This provision confirmed the Government's commitment from the above-mentioned memorandum of March 1991, in which prudent credit policy and respecting the policy of hard budget constraints were envisaged. Also, the government's letter of intent from September 1993 reaffirms that "official foreign borrowing and the guaranteeing of external borrowing would *continue* to be limited."[483]

As I showed above, Poland also could not use another conventional measure (aside from foreign credits) for closing the deficit gap, namely, foreign exchange reserves. This was because it was already obliged under the agreement with the Paris Club. This explains why the government could not follow the advice given by Marcin Wyczałkowski, who in a letter to Russo of July 1991 argued that once inflation was stabilized on a certain level, this could bring about an increase in the demand for money. Then, money supply in the economy should be increased through a combination of the utilization of export surpluses and new foreign loans.[484] This would boost imports of goods necessary to increase the domestic production without inflationary effects, and would bring benefits to the budget.

However, Wyczałkowski failed to take into consideration the stipulations of the agreement with the Paris Club signed two months earlier. New foreign credits were inflationary and increased mid- and long-term debt service, while the aim of the struggle for debt reduction was to facilitate the reform through lowering the debt service burden. In turn, reserves as the key criterion of external viability served as a guarantee of Poland's solvency. Hence, the prospect of completing debt reduction limited the scope of possible measures for preventing further growth of the budget deficit.

In the situation of so narrowed room for maneuver, the IMF assistance in ensuring for the government additional resources for financing the deficit became increasingly urgent. Once

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[482] *Memorandum of the Government of Poland on Economic Policies*, December 1992. Archives of the Ministry of Finance, A/822/29 (31.05.1991-16.12.1993, 244 pages).
[483] *Letter of Intent*, September 2, 1993 (An attachment to: *Republic of Poland – Review under Stand-By Arrangement*). Polish Transformation. Documents...., 1991-1993, p.842.
[484] IMF Archives, Poland, Correspondence and Memos, July-September 1991 File 3, M. Wyczałkowski, *Poland:Effects of the Reform and Proposed Policies*, July 5, 1991.

again, attempts taken by the Fund to organize external financing – although not always effective – confirmed the exceptional commitment of this institution to make the Polish reform successful even if consequences of such aid were in conflict with the interests of the Paris Club countries.

The proposal of external financing of the deficit first appeared in bilateral negotiations in October 1991. The Vice Minister of Finance Stefan Kawalec pointed to the fact that even though the situation regarding reserves was quite safe, the budget situation was tragic, as expenditure could not be limited any further. The government thus planned to take in short term fiscal unconventional measures in the form of external financing. In this context, Kawalec attempted to determine in his conversation with Allen the potential readiness of G-24 countries to grant assistance. He also emphasized that although foreign financing was necessary, it was only temporary. Once the tax system reform planned by the government started generating income from taxes on the private sector and personal consumption, external financing would no longer be needed. Still, until that moment, the need to maintain the current level of spending would lead to a considerable fiscal deficit, which required external financing if it was not to be inflationary. Kawalec also warned against further cuts in expenditure as it could threatened political stability.[485]

The Fund approved external financing as a means for financing the deficit, yet no other purpose (such as increase of consumption or investment imports). Ultimately, external financing was taken into account under 'performance criterion' regarding new external debt, yet as a separate category, i.e. the limit of the new external debt did not include 'external financing' granted to the government. The IMF declared also that it would try to use good offices in bringing external financing into force.

However, external financing, even with the Fund's help, proved extremely difficult to receive. Western countries did not want to grant financial support to Poland due to a lack of any convincing reason. In September 1991, Russo admitted that prospects for foreign financing were bleak, still, despite the Fund itself being engaged in this issue, he justified credit abstinence of governments due to the lack of a balance-of-payments financing gap.[486] However, as I try to prove below, the main argument against additional lending to Poland was

[485] IMF Archives, Poland, Correspondence and Memos, October-December 1991, File 4, *Poland - Some Background for your Discussions*, October 10, 1991.
[486] IMF Archives, Poland, Correspondence and Memos, July-September 1991 File 3, M. Russo to the MD, September 21, 1991.

the granting of the first tranche of debt reduction 1991 and the prospect of the said reduction being completed in 1994.

Debt reduction recently granted to Poland and the related comfortable external position as the factors diminishing chances for additional financial assistance from the West were mentioned by Stefan Kawalec in the very same conversation in which he pointed to Mark Allen the necessity for external financing.[487] In turn, the IMF report on financing needs of the Central and Eastern European Countries, published in September 1992, proved that these weak prospects for external financing due to debt reduction remained unchanged throughout the year. It was stated in the report that the balance-of-payments assistance granted by the G-24 countries would decrease in 1992 for all countries of the region. More importantly, as the report emphasizes, there would be no need for additional exceptional financial assistance for Hungary and Poland. In reference to the latter, the report claimed that this was due "the substantial frontloading of cash flow assistance included in the reduction of official debt."[488]

Before the Polish government asked the Fund for support in convincing Western governments to grant additional financial assistance to Poland, it undertook an individual effort to obtain these funds. Poland could not use the IMF resources under the EFF and for that very reason, it attempted to find a way to finance the deficit without the mediatory role and knowledge of the IMF. In December 1991, a representative of the Polish government turned directly to Vice President of the European Community, Henning Christophersen, to ask for an 800-million-dollar loan.

In the telephone conversation between another EC representative and Biswajit Banerjee, a member of the IMF mission to Poland, the former stated that the purpose of the required financial assistance was unclear to him, but on the basis of the language and terms used by the Polish representative, he concluded that the request was related to budgetary deficit. For that very reason, a reply of the EC was by necessity negative. More precisely, the refusal was justified by the lack of a need for balance-of-payments financing in 1992, and this was the only justification the EC could accept. More importantly, it was argued that "Poland had already received substantial balance-of-payments relief through official debt reduction, and a

[487] IMF Archives, Poland, Correspondence and Memos, October-December 1991, File 4, *Poland - Some Background for your Discussions*, October 10, 1991.
[488] IMF Archives, *Exceptional Balance of Payments Assistance for Central and Eastern European Countries - Review of Experience in 1991 and Preliminary Estimates of Financing Needs for 1992*, p. 10; http://archivescatalog.imf.org/detail.aspx.

new request for assistance was unlikely to be received well by the G-24."[489] The lack of external financing was thus justified by the fact that Poland had already received one debt reduction tranche and the second tranche was conditional on further implementation of the reform.

In line with the above, the stance adopted by the European Commission was clear on determining the role of the IMF in organizing financial support for Poland in the near future. It stipulated that the financing need would have to be examined in the context of a new program with the IMF, and the latter should discuss the matter with the European Commission before agreeing on a scenario with the Polish authorities.[490] Hence, no decision on additional financing from abroad for Poland could be taken without the consent of the Fund and the EC. From March 1992, when the informal consensus was made with the IMF, Poland abandoned efforts to obtain external financing that excluded the mediatory role of the IMF. Still, as a consequence of the fact that the government was doomed to use the Fund's help in gaining external financing, it had to ensure it that Poland returned on the path of the reform.

In the light of bleak prospects for obtaining additional financial support for Poland from the European Commission, the Polish government together with the Fund considered an alternative solution. Poland tied high ambitions to the proposal to re-activate the Stabilization Fund to finance the infrastructural projects by the EC or to recapitalize banks. Unofficially, however, the government needed foreign money for budgetary support. Faced with the Fund's skeptical approach to the possibility of implementing that concept, Deppler suggested a temporary import surcharge as a more effective way of attracting additional resources and one that might be more acceptable to the creditors.[491]

Although Poland was not granted direct financial support in the form of new loans, in March 1993, Western governments agreed to keep in force a temporary tax in the form of import surcharge, which was introduced in December 1992. It was to be removed in 1994, but Poland managed to extend the approval to maintain it beyond that year. Concessions made by GATT for Poland in the form of the consent to introduce and then maintain import surcharge, and to impose a 25-35 percent high customs tax on imports of agricultural products proved that

[489] IMF Archives, Correspondence and Memos, October-December 1991, *Poland - Telephone conversation with Mr. Fleming Larsen on Poland's Request for Financial Assistance,* December 3, 1991.
[490] Ibid.
[491] IMF Archives, Poland, Correspondence and Memos, January-March 1992, M. Deppler to the MD, February 14, 1992.

Western governments were still ready to support the unprecedented transformation reform in Poland.[492] These were the subsequent stages of a long process of granting financial support for an exceptional reform in Poland, which started in January 1990 from the establishment of a 1-billion-dollar Stabilization Fund, and cumulated in the granting of an unprecedented 50 percent reduction of the official foreign debt.

5. "The state of the budget determines your credibility"

Western governments did not want to grant external financing in the form of direct credits to the Polish government, yet they agreed for the import surcharge, since the first form of assistance was not compliant with objectives of the transformation reform supported by the West. In turn, the need for import surcharge was justified by Poland and IMF representatives at the GATT forum by the need for maintaining external viability.[493] Importantly, the side effect of this policy of the European Commission towards Poland was a necessity for the Polish government to arrange deficit financing that would force proper restrictiveness of the macroeconomic policy. In this indirect way, Western governments contributed to the Polish government not getting off the course to the rapid transition reform.

The fact that the lack of external sources of financing translated into prudent fiscal policy was emhasized by the president of the NBP Hanna Gronkiewicz-Waltz. In an interview of September 1993, she pointed to the fact that many politicians demanded that the deficit be increased and the "famous 5 percent" be exceeded. However, in her view, the problem did not lie in this strict target, but in the method of financing the deficit. To confirm this, she acknowledged that in 1992, "the deficit was several trillion zlotys smaller because methods of financing it could not be found."[494] In turn, the Minister of Finance in the last 'Solidarity' government Jerzy Osiatyński claimed in August 1992 that the financing of the increased deficit was a crucial matter, but the government did not count on external financing anymore and, hence, the entire deficit would have to be financed from domestic sources.[495]

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[492] Such was the official justification for the approval of the temporary import surcharge.

[493] IMF Archives, Poland 1993, *Poland Statement by the Fund Staff Representative to the GATT Balance of Payments Committee*, March 15, 1993.

[494] Interview with H. Gronkiewicz-Waltz, the Governor of the National Bank of Poland. *Rzeczpospolita*, September 21, 1992.

[495] Interview with J. Osiatyński, the Minister of Finance. *Nowa Europa*, August 14-16, 1992.

Was the tightening of financial discipline a mere side effect of the lack of access to external financing or rather an intentional action of international community towards Poland? One may argue for the latter interpretation. In the entire Central and Eastern European region, IMF-supported programs of macroeconomic stabilization aimed at tightening fiscal situation to suppress inflation. Adoption of this shape of the reform by countries in this region entailed specific consequences for the budget policy. According to the Fund's report on the financing needs of the East-European countries, "in some cases, limits on budget deficits in order to reduce inflationary pressures and the need to contain domestic demand, consistent with the maintenance of uninterrupted debt service or other perceived external constraints, severely restrict resources available in the reforming countries."[496] It seems then that fiscal stabilization was the main measure of Poland's credibility and Western governments did not want to take on the Polish government's difficult task of financing the deficit. Poland was expected to complete the reform it obliged itself to in 1989 and regain credibility it lost in 1991 due to abandoning the economic program arranged not only with the IMF but also with Western governments.

In early 1992, one of the key economists of the World Bank, Ian Hume, referred in his dispute with the Fund representative that the official commitment of the Polish government to the 5-percent deficit target for 1992 was designed to be a sign to the international community.[497] Regardless of whether the IMF considered actions more important than declarations, the above Hume's statement shows that the credibility of a reforming country was closely linked with its budget policy.

An important role in disciplining Polish reformers and reminding them of the credibility criteria of Poland abroad was played by foreign economic advisers to the government. In a letter to Leszek Balcerowicz written by the end of 1990, Jeffrey Sachs and David Lipton stressed the key importance of influence exerted by the budget policy in 1991 on the success of the reform in the following years. According to them, this influence would be positive if the budget policy sacrificed today's consumption for the wellbeing of tomorrow, and, as such, it would be an important signal to the international community.[498] The Sachs-Lipton duo reminded the very same message to the government headed by Jan Olszewski immediately after it was appointed in January 1992. The former economic advisers stressed in the letter to

[496] *Exceptional Balance of Payments Assistance for Central and Eastern European Countries*..., p. 11.
[497] IMF Archives, Correspondence and Memos, Jan.- March 1992, File 1, M. Allen to M. Deppler, January 15, 1992.
[498] Sachs' and Lipton's letter to Balcerowicz, October 23, 1990. „Polish Transformation. Documents and..., 1990"; p. 510.

the Polish authorities that strict financial policy overlapped with the European credibility of the program, stating: “In order to attain the necessary international financial assistance, the new Government must establish its credibility as a market-oriented, European-oriented, fiscally responsible government.”[499]

One month later, just before the vote on budget in *Sejm,* Michel Camdessus in his letter to President Lech Wałęsa and Prime Minister Jan Olszewski referred to expectations of Western financial institutions regarding the adoption of the restrictive budget in Poland. The Managing Director called the Polish authorities to observe that “the new budget not undo the significant progress towards financial stability achieved over the past two years and instead demonstrate Poland's continuing resolve to seek non-inflationary growth and market-oriented reform.”[500] The adoption of a properly restrictive project would determine how Poland's prospects will be viewed by the international financial community.

For the international financial community, Poland’s credibility did not mean merely liquidation of the debt overhang, but primarily a prudent budget policy that would minimize the threat of another fiscal profligacy, which could lead to a new ‘credit fever’, like the one in the 1970s. In this sense, the ‘European’ credibility of Poland, which was related to the implementation of the rapid transition reform launched at the end of 1989, was the key to financial credibility. This was pointed by Sachs and Lipton in the mentioned letter to Leszek Balcerowicz, where they claimed, “the budget is the single most important political and economic statement of the Government both to the Polish population and to the international community (creditors, donors and potential investors).”[501]

When concluding the issue of external financing one should admit that the Polish authorities fell into a trap that they themselves constructed. Due to the willingness to obtain the second tranche of debt reduction not later than in April 1994, they had to continue the implementation of restrictive fiscal policy. Binded by the Paris Club Agreement from 1991, the government could not conduct a more expansive financial policy by using foreign reserve assets, credits from Western governments or those from the IMF. Yet, the prospect of debt reduction additionally influenced the restrictiveness of the reform. In March 1992, according to the Fund’s estimates, the underlying deficit for 1992 reached nearly 16 percent of GDP.

[499] IMF Archives, Correspondence and Memos, January-March 1992, J. Sachs, D. Lipton, *Goals for the New Government. Some Preliminary Ideas*, January 27, 1992.
[500] IMF Archives, Correspondence and Memos, Jan.- March 1992, File 1, *Letter from the Managing Director to Lech Wałęsa and Jan Olszewski*, February 1992.
[501] *Sachs’ and Lipton’s letter to Balcerowicz…*

The government lost a year of the three-year 'window of opportunity' period it was granted in March 1991 to implement stabilization-cum systemic reform and, thereby, to 'deserve' the second tranche. This year-long delay meant that if the government was to be granted the full debt reduction in the original timeframe, it had to accelerate its efforts and thus tighten fiscal adjustment.

6. The Fund misled again: another fiscal relaxation

After a year-long state of limbo in the Fund-Poland cooperation, in the late summer of 1992, the IMF mission was planning to come to Warsaw to reach an agreement on macroeconomic policy, which was a prerequisite for obtaining the second tranche of debt reduction.[502] Meanwhile, in July 1992, the IMF mission discovered that in May, when a new SBA program with the set 5-percent fiscal target was one step away from entering into force, the government underestimated the deficit again.[503] The staff noted that the state budget deficit target of 65.5 trillion zloty (5.6 percent of GDP) would be exceeded by a significant margin: on the basis of currently planned measures, the deficit in 1992 was more likely to be more than 110 trillion zloty (9.5 percent of GDP). Furthermore, according to the staff estimates, the real deficit for 1993 was 130-150 trillion zloty. The staff concluded that there was a shortfall in revenues in the budget for 1992 of about 3.6 percent of GDP.[504] In this way, the mission pointed to the preferred way of carrying out fiscal adjustment - the main burden of adjustment was to rest on increasing revenues rather than on spending cuts.

To understand the meaning of this yet another 'failure' of the government, it is worth to recall the broader context. In the first quarter of 1991, the government had pledged in a Letter of Intent to implement a particular policy at a particular time but abandoned it immediately upon receiving the first tranche of debt reduction by 30 percent. As the second tranche was conditional upon the *implementation* of a three-year economic program agreed with the IMF in 1991, a new arrangement (after terminating the 1991 EFF) had to be 'realistic', so that the government was able to bring the required policies into force. However, in the late spring of 1992, that is, already after the informal March consensus was concluded and immediately

[502] Interview with S. Gomułka. „Polish Transformation, Documents..., 1991-1993", p. 56.
[503] IMF Archives, Correspondence and Memos, April-Sept. 1992, M. Russo to the MD, *IMF staff visit*, August 27, 1992.
[504] Ibid.

before the signing of the new agreement with the IMF by the government, it turned out that another budget relaxation was prevented only due to the vigilance of the Fund.

Another significant mistake made by the government in the budget project made keeping the 5-percent deficit recently agreed with the IMF impossible and forced relaunching of budget negotiations. Thus, the IMF grew increasingly more frustrated and both parties became more aware that another budget miscalculation by the government could be seen by the Fund mission as *deliberate* and lead to a termination of the cooperation. The economic situation was not facilitated by a government crisis. The lack of government in June-July 1992 reflected in the loosening of the financial discipline of enterprises, which drastically deteriorated the budget forecast for 1992.[505] On the one hand, the lack of both paid taxes and servicing of loans by enterprises increased the deficit on the revenue side. On the other hand, the pressures on wages increased enormously, resulting in higher budget spending. The outcomes of the government crisis had an immediate effect on the budget. While in January-May, the monthly budget deficit was around 3 trillion zloty, in June alone it reached as much as in the first five months of the year, that is, about 15 trillion zloty.[506]

If one was to assume the forecast of the Ministry of Finance of July 1992 that envisaged a deficit of 100 trillion złoty in 1992[507], this would mean that over the previous six months of that year, the monthly deficit was estimated at 12 trillion złoty on average, which gave an over 10-percent GDP deficit in 1992. It should be stressed that the key issue for the IMF and the NBP was to avoid an increase in inflation in 1993 compared to 1992.[508] The minimum requirement for obtaining an assumed limit of a 35-45 percent high inflation in 1993 was that an adequate deficit level had to be reached in 1992, and that required the deficit to be reduced from the level of 100 billion złoty (over 9 percent of GDP) foreseen for 1992. The government, however, still could not implement the economic policy agreed on with the IMF, while the deficit continued to grow. This situation made the Fund mission resort in negotiations with the government to the argument of the receding prospect of debt reduction.

[505]S. Gomułka to J. Osiatyński, *Popiwek, restrukturyzacja długów, zmiękczenie ograniczenia budżetowego przedsiębiorstw* [Popiwek, debt restructuring, softening of the budgetary constraints of enterprises]; Polish Transformation..., 1991-1993, p. 564.

[506] S. Gomułka to J. Osiatyński, *W sprawie rozmów z MFW i budżetu na lata 1992-1993* [*On the consultations with the IMF and state budgets for 1992 and 1993*, 15.08.1992], „Polish Transformation. Documents..., 1991-1993", p.580.

[507] Letter from S. Gomułka to J. Osiatyński, 22.07.1992. „Polish Transformation. Documents..., 1991-1993"; p. 564.

[508] *On the consultations with the IMF...*

The exchange of letters between the Minister of Finance Jerzy Osiatyński and his key economic adviser Stanisław Gomułka from the summer of 1992 indicates that the two objectives were correlated. In late June, Gomułka informed Osiatyński that for the IMF, a 100-trillion-zloty high deficit was absolutely unacceptable, although the Fund probably could agree to a deficit of about 7 percent (80 trillion zloty). This, however, would require a swift agreement. According to Gomułka, Mark Allen named the debt reduction issue as the major justification, stating that "an agreement with the IMF should cover the fourth quarter of 1992 if Poland wants to save the agreement with the Paris Club on the term for the second stage of debt reduction (April 1994). Without the fourth quarter, the entire 1992 is lost and the Paris Club most likely will demand that the term is postponed for a year."[509]

In August, Gomułka warned Osiatyński saying to him: "history will judge you not for giving more popularity to your own political party, but for saving 20 percent of debt reduction and preventing deep financial crisis."[510] Considering Gomułka's position as adviser to all Ministers of Finance in 1989-1993, it can be assumed that these were the two major tasks the Suchocka government had to face. Gomułka formed the core of the group of the economic reformers, who in 1989-1993 struggled to maintain the reform momentum against the turbulent domestic political climate. In the 1980s, he served as an adviser to the IMF on Poland. To use a metaphor, he acted as a 'compass' that helped governments find their way in a complex web of international financial institutions, their rules and practices. His experience proved all the more helpful in late 1992, as the new government was taking power in the absence of any political continuity with the previous government.[511] Meanwhile, in the late summer of 1992, the IMF mission was coming to Warsaw, and Gomułka together with two Deputy Finance Ministers tried to figure out how to reach an agreement with the IMF on macroeconomic policy, which was a prerequisite for obtaining the second tranche of debt reduction.[512]

Eventually, in September 1992, just before the launch of fiscal adjustment in the last quarter of 1992 (as expected by the IMF), Massimo Russo referred again to the running-out-of-time

[509] Gomułka S. *My today's conversation with M. Allen and its implications*, 28.07.1992. Polish Transformation. Documents, 1991-1993, p. 568.
[510] S. Gomułka to J. Osiatyński, *Strategia przygotowań merytorycznych i politycznych do rokowań z misją MFW oraz NBP w sprawie listu intencyjnego* [*A strategy for substantive and political preparations for negotiations with the IMF mission on the letter of intent]*, 19.08.1992. „Polish Transformation. Documents..., 1991-1993", p. 585.
[511] In the period 1989-1993, the Olszewski government was the only one which openly and consistently advocated anti-communist ideas – a policy that ultimately led to its collapse.
[512] Interview with S. Gomułka. „Polish Transformation. Documents..., 1991-1993", p. 56.

argument. Pointing to a minor slippage with respect to measures for the fourth quarter of 1992, Russo advised Camdessus to urge Osiatyński to come to terms on a Fund program and, more importantly, to tell him that "the Paris Club creditors will not be patient indefinitely."[513] This was to be the key argument to be used by Camdessus to discipline Poland: it aimed to make the government realize that in the current state of inertia in economic policy, granting the second tranche became highly uncertain.

7. A breakthrough: the government takes action

The external pressure on the government to accelerate the reform if it wanted to secure the original term of the second tranche of debt reduction proved effective. In September, the government finally started to take fiscal adjustment actions. This was possible also due to a better political situation. The new government headed by Hanna Suchocka that took over power in July 1992 had a much better relations with President Lech Wałęsa.[514] The new government was also far more open to dialogue with other political forces, including discussions on economic policy issues.

The shape of the new economic policy of the government was fundamentally influenced by Stanisław Gomułka.[515] In August 1992, referring to yet another erroneous budget estimates, Gomułka, as the key adviser to Osiatyński, advised him to plan the new budget as follows: "The budgeting group in the Ministry of Finance cannot mislead the government once again. [...] The philosophy of stimulating activity by underestimating budget deficit must be absolutely rejected" and only "realistic - not cosmetic and insecure - measures would make impression abroad (the IMF) and at home."[516] He also stressed that had the new arrangement been signed in May 1992, that is, before the above-described discovery of the mission, Poland again would not have been able to fulfill the performance criteria. For that very reason, Gomułka concluded, it was "absolutely unacceptable to repeat that situation during the next 18 months."[517] Therefore, it was necessary for the government to prepare a 'realistic' program

[513] IMF Archives, Correspondence and Memos, April-September 1992, *Update on Brief for Meeting with Delegation*, September 21, 1992.
[514] The former government headed by Jan Olszewski accused Wałęsa of collaborating with the communist security services. This became the main reason for the government being dismissed.
[515] Confirmed during the author's conversation with Stefan Kawalec, the Vice Minister of Finance in Suchocka's government.
[516] S. Gomułka to J. Osiatyński, *On the consultations with the IMF...*
[517] Ibid.

with a very careful budget forecast. Gomułka saw no alternative to putting forth a very restrictive budget in case it turned out that it was again excessively unbalanced.

It is worth to note that at the beginning of his term of office the Minister of Finance Jerzy Osiatynski was far from the stance he would adopt six month later at a speech in the *Sejm* in defense of the budget on February 12, 1993, when with the consent of Prime Minister Suchocka, he made the future of this government dependent on the approval of the 5-percent GDP deficit. However, in July 1992, Osiatyński told Allen that the 5-percent GDP fiscal target was unattainable and asked him to discuss what was realistic and that “they should not just be slaves to a number that had been selected in the past.”[518] In early August, Allen wrote to Deppler that as long as Osiatyński remained weak and failed to realize he could not make any exceptions from the 5-percent deficit target set in May, no agreement would be concluded. Allen recalled Osiatyński’s predecessor Andrzej Olechowski as a model for the former, since the latter adopted and forced through in the *Sejm* the TINA approach (There Is No Alternative) towards the 5-percent GDP deficit.[519] In mid-September, Allen informed the Fund management that the passiveness and lethargy of the Polish authorities’ response to the difficult economic situation was particularly striking.[520] Four days later, in a private conversation with the Minister of Finance, Allen informed him of the IMF decision: the government was deemed not ready to implement essential and difficult macroeconomic measures[521] and, hence, no new program with the IMF would be made before the Annual Meetings.

Two weeks later, in early September, the situation of cooperation between Poland and the Fund was completely different. As Deppler noticed in his memo to Camdessus of September 10, the discussions with the new Government held in Warsaw from September 1 to 8, were encouraging.[522] Deppler also saw grounds for an imminent conclusion of a new SBA program if the government maintained the current pace of action. He noticed progress particularly in two areas: creating political support and technical work on additional measures. Eventually, the government adopted a deficit for 1992 at the level of 85 trillion zloty (7.5 percent GDP), which was approved of by the IMF. Deppler praised the authorities for putting together a

[518] IMF Archives, Correspondence and Memos, April-September 1992, *Meeting with Minister Osiatynski*, M. Allen to M. Deppler, July 22, 1992.
[519] IMF Archives [...], *Poland - Macroeconomic Policy and the New Authorities*, M. Allen to M. Deppler, August 7, 1992.
[520] IMF Archives [...], *Poland -Additional Information from August Mission*, August 19, 1992.
[521] IMF Archives [...], *Meeting with Minister Osiatynski*, M. Allen to M. Russo, August 23, 1992.
[522] IMF Archives [...], *Poland-Report on Staff Visit*, September 10, 1992.

major package of deficit containment measures and, more importantly, for taking significant action as regards public enterprise restructuring-cum-structural reform.[523]

The fiscal package, which can be called the ‘Gomułka package’, included, among others, increases in indirect taxes, a 10-percent surcharge on about 75 percent of imports, and cuts in social expenditures, mainly pensions. With these three measures reducing the deficit by about one and one-third percent of GDP, and other measures yielding an additional half percent, all together gave 1.5 percent required for financing the 9-percent GDP deficit foreseen in July, so that the agreed deficit target of 7.5 percent of GDP be met.[524] Importantly, these measures were of a permanent rather than a one-time character and they were planned to take effect in the fourth quarter of 1992. Hence, it was a fulfilment of the Fund’s inviolable requirement of replacing ad hoc measures with permanent systemic changes.

The permanent character of the additional measures was to act primarily for the benefit of attaining the proper deficit level in 1993, which was estimated by the authorities and the mission at about 5 percent GDP. Attaining this budget objective required foreign financial support. The IMF obliged itself to organize such support provided that the government continued strict fiscal policy. Most importantly, implementation of this deficit target in 1993 required structural reforms. Deppler summarized the breakthrough September mission in Warsaw, describing the government’s intention: “this is not only talk: specific measures are in the pipeline.”[525] To confirm this, he listed the mass privatization and VAT bills that were both before the Parliament, the bank and enterprise restructuring project with the World Bank that was under way, tax administration that was being strengthened, administration of social expenditures that was being improved as well as the functioning of social safety net.

8. “The ultimate payoff for Poland from arrangement with the IMF”

Due to the noticeable change in the government’s approach to the financial crisis, a shift also took place in the IMF’s approach to Poland with the plan to conclude a new agreement soon. In late November, IMF Mission Chief Michael Deppler in his back-to-office report informed

[523] Ibid.
[524] The 1992 fiscal adjustment was very effective as it reduced the deficit from the level of 10 percent of GDP estimated for summer’92 to 6 percent of GDP for the whole year. This achievement paved the way for the new stand-by arrangement concluded in March 8, 1993.
[525] Ibid.

the Managing Director of joint arrangements made with the government on the new program, which pertained to deficit targets in 1992 and 1993, instruments of fiscal adjustment, and the level of inflation in 1993. However, what is more interesting than the specific macroeconomic indicators were the underlying principles of the negotiated economic program, which acted more as a background for Deppler's report than its essence. These point to the unique character of the Fund-Poland cooperation, and, more importantly, confirmed the viability of 'the March consensus'.

Having presented the key elements and objectives of the SBA program in 1993, Deppler proceeded to address the risks of the program and claimed: "The foregoing policies are deserving the Fund support. Further grounds for thinking that this arrangement may be more robust than many lies in the fact that the ultimate payoff for Poland from this arrangement – the second tranche of the Paris Club operation – requires continuous compliance with the arrangement."[526] Debt reduction appeared thus the greatest safeguard of the implementation of the reform and it was the reduction that made the Polish program stand out from others.

That being said, Deppler pointed to risks of the program that still required consideration. First, he listed political risk in the form of uncertainty whether and when the budget would be adopted by the *Sejm.* He then focused on economic risks that were closely related to the 'memory' of the previous budget estimates and performance. Deppler was concerned that some items in the budgetary plan, notably interest expenditures, were probably underestimated. Nonetheless, he immediately stressed that "fortunately, this also applies to some of the revenues, which in reaction to the 1992 experience, have been conservatively estimated."[527] Therefore, Deppler confirmed the actual effect of the 'memory' factor on the Polish authorities. At that time, due to the wrong estimation of revenues in May 1992 that came to light several months later and prevented the 5-percent deficit formerly agreed on with the IMF from being maintained, the government was excessively vigilant and would not make the same mistake again. Further cooperation with the IMF was at stake, and the second tranche of debt reduction depended on it.

From there, it took only one step to construct a very tight budget that would imply fiscal adjustment with a sufficient 'reserve'. As the main feature of the 'ad referendum' agreement with the Polish government, Deppler emphasized a decline of the deficit from 8.5 to 4 3/4

[526] IMF Archives, Correspondence and Memos, October-December 1992, *Poland: Back-to-Office-Report,* M. Deppler to the MD, November 24, 1992.
[527] Ibid.

percent of GDP from 1992 to 1993. The budget to be approved by the Parliament would have a 5-percent large deficit (provided there would be no private debt reduction). Most importantly, however, an understanding was reached on a "marked fiscal adjustment beyond that suggested by the change in the deficit"[emphasis added], that is, through revenue and expenditure measures of some 4-5 percent.[528] Adjustment to the reserves was expected by the IMF to prevent the events of May 1991 and May 1992 from happening again, when the government set fiscal targets with the Fund and then failed to fulfil them, as they were based on overly optimistic basis. Now, for greater certainty, the government had to assume a more realistic deficit, which was manifested in fiscal adjustment larger than the assumed deficit difference between 1992 and 1993.

The government's determination to apply fiscal adjustment beyond the targeted deficit was confirmed by the Memorandum of Economic Policies written together by the Fund and the government in December 1992. Referring to the risk of subsequent slippages in the budget implementation that would reignite inflation, the government obliged itself to take further fiscal actions as required to ensure that the program targets were met.[529] On the revenue side, the Government undertook to raise excise duties and consider more rapid reduction of subsidies. More importantly, and this again confirmed the government's will to undertake precautionary measures, expenditures were to be kept to within 45 percent of the budgeted annual total during the first half of the year[530], and the Ministry of Finance was to continue to link expenditures to revenues.

In his document, Deppler de facto confirmed the existence of the close correlation between debt reduction, the 'memory' of revenue overestimates and deviations from the agreed macroeconomic program and the necessity for fiscal adjustment with a sufficient'reserve'. More precisely, the joint effect of the first two factors, namely, the prospect of debt reduction and exclusion of a situation where the Fund was yet again misled, required fiscal adjustment with the 'reserve' and hence ensured the success of the new reform program. Deppler also directly admitted that the 'differentia specifica' of the Fund's program in Poland took the form of the desire to receive the second tranche, which would determine the success of the reform.

[528] Ibid.
[529] *Memorandum of the Government of Poland on Economic Policies*, December 1992. Archives of the Ministry of Finance, A/822/29 (Cooperation with the IMF: May 31, 1991-December 16, 1993, 244 pages).
[530] Ibid.

9. The origins of the "hara-kiri approach"

Finally, at the turn of 1993, a situation occurred that created a prospect for a new agreement between Poland and the IMF being concluded in the short term. The Fund obtained proof of the government's determination to effectively implement the economic program in the fourth quarter of 1992, when durable instruments guaranteeing prudent fiscal policy were introduced, especially with a view for 1993. However, when it seemed that there were no more obstacles that could hinder the conclusion of the said agreement with the Fund, in the first quarter of 1993, a problem of a political nature emerged, which Deppler had predicted in his document from November. Namely, the *Sejm* refused to adopt the 1993 budget. Below I attempt to prove that the factor that mobilized the reformers to insist on the adoption of the budget was the desire to save the original time of the second tranche of debt reduction. Adopting the budget project for 1993 was undoubtedly the most difficult condition for the conclusion of the agreement with the IMF. In order to meet that condition, Prime Minister Hanna Suchocka played va banque and confronted the *Sejm* with a dilemma, "If you want this Government, you have to have its budget."[531] The issue at stake was losing or gaining, as described by the Minister of Finance Osiatyński, several tens of billions of dollars.[532]

On the one hand, the political situation did not look optimistic, because since the beginning of the year, the *Sejm* had adopted three amendments to the budget, which together with several other decisions raised the deficit by 20 trillion zloty: the costs of the vote on housing subsidies was 3 trillion, whereas on budget sector wages was 6-7 trillion, and that on VAT on energy was 2-3 trillion zloty[533], while under the pessimistic scenario, the loss for the budget would amount to 40 trillion zloty. On the other hand, in January 1993, there were only 14 months left to grant the second tranche of debt reduction within the original time limit. It meant that IMF stand-by agreement had to be reached as soon as possible, since it typically covered a period not shorter than 12 months. The time pressure and excessive claims of political parties fueling the budget deficit made Osiatyński begin to seriously consider the political option in solving the problem, namely, the risk of the resignation of the government in case the budget project was not adopted by the *Sejm*.

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[531] *Prime Minister Hanna Suchocka's speech to Parliament*, February 12, 1993.
[532] Interview with J. Osiatyński, the Minister of Finance, *Przekształcenia i życie* [*Transformation and Life*], January 1993.
[533] Gomułka S., *Notatka o moim spotkaniu z M. Allenem* [*Note on my meeting with M. Allen*], January 21, 1993. „Polish Transformation. Documents..., 1991-1993", p. 727.

Such a radical idea could appear only in a situation of a substantial threat to the conclusion of the IMF program, when the initially planned 20-month SBA would shrink to an uncertain prospect of a program lasting for 14 months. The budget adopted by the *Sejm* in May 1992 was no longer valid due to the political crisis, and from that moment, the deficit was constantly growing. In the course of the one-year budget negotiations, the *Sejm* faced an increasing number of political obstacles to reaching an agreement on a common version of the draft budget. Under such circumstances, the Suchocka government decided that the only solution is to put the continuation of the government on the line, as it realized that through laborious political negotiations it would never be able to force through such a restrictive budget. Paradoxically, Osiatyński's unique determination stemmed from a sense of powerlessness in such a hopeless political situation. The stakes were too high to amend the budget again and postpone vote. It was the time pressure that necessitated the "hara-kiri approach", yet the time pressure itself was caused by the intention to complete official debt reduction.

These origins of the government's radical decision were indicated in an interview with Minister Osiatyński of January 1993, where he stated that the budget was considered by Western financial institution the key criterion of Poland's credibility, and thus financial assistance from the West depended on whether the budget was adopted. He emphasized that the negotiations with the IMF were underway, but could not be concluded until budget draft was questioned by the *Sejm*. Thus, the Fund's authorities were still waiting for the government to specify its stance on this matter.

Next, the Minister of Finance moved to details and pointed to the consequences of the draft budget supported by Western governments and financial institutions being rejected. In his opinion, World Bank loans for agriculture and road building would be suspended, and the conversion of a one billion dollar Stabilization Fund to the bank and enterprise restructuring project would be suspended as well. Finally, there would be no grounds to proceed with the second tranche in the Paris Club and access to negotiations with the London Club would not be granted. Lastly, the Minister somewhat exaggerated when warning that several tens of billions of dollars were at stake, and that the loss of such a financial reinforcement would be "a genuine disaster" for Poland.[534] As can be seen, Osiatyński's main argument for budget approval was the fact that Poland would receive vast financial support.

[534] Interview with J. Osiatyński, *Przekształcenia i życie...*

Prime Minister Suchocka spoke in a very similar way in the *Sejm* on February 12, 1993 right before the vote on the government's draft budget. She stressed that budget approval would create a possibility for a cooperation with international financial institutions and that as a result of rejection, the opportunity for a 12-billion-dollar debt relief would be lost.[535] When continuing the topic of debt, she clearly emphasized that increased deficit was a proposal to live on the cuff, since "society cannot apply management rules that do not follow the logic known to every family. Hardly any family spends more that it has. Future generations cannot be burdened with debts that are difficult to repay. In the scale of the country, we have experienced such a situation in the 1970s – and we are still experiencing its outcomes today."[536]

Lastly, Suchocka left no doubt as to the seriousness of the situation, claiming: "If the parliament adopts a budget that cannot be implemented according to the government, the latter cannot be held responsible for the implementation. In democracy, this means resignation of the government (...)". At the very end, she repeated: "If the parliament adopts a budget that cannot be implemented – a budget of false expectations and destabilization - the government will have to step down."[537]

It is clear from the above statements of Minister Osiatyński and Prime Minister Suchocka, that adoption of the restrictive budget by the *Sejm* confirmed subsequently by the Fund's seal of approval in the form of a new economic program would be considered by Western governments a green light for maintaining the original debt reduction term. This form of financial support from the West was most important for the government. Both ministers of finance in the years 1992-1993, i.e., Andrzej Olechowski and Jerzy Osiatyński, in their numerous conversations with representatives of the IMF stressed at that time that early conclusion of a program with the IMF and the necessity to keep the original debt reduction term were inextricably linked. As such, it was not the agreement with the IMF that was the objective, but its consequences in the form of the second tranche of debt reduction set for April 1994. This short timeframe meant that there was no time to hesitate and that the IMF program had to be concluded if the official debt reduction process was to be concluded as originally scheduled.

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[535] When describing consequences of the budget rejection, the Prime Minister first pointed to the fact that an inflation tax would be imposed on society, while inflation itself would exceed 100 percent a year as a result of the deficit that would increase to 160 trillion zloty. This would jeopardize the strategic objective of the reform, i.e., permanent economic growth.
[536] *Prime Minister Hanna Suchocka's speech to Parliament...*
[537] Ibid.

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Polish reformers have often stressed their own achievements and full independence in devising and implementing the economic program between 1989 and 1993[538]. In their view, such a historic, momentous undertaking as systemic transformation could not be carried out according to the prescriptions of Western liberal economists. And, indeed, it was not. Poles had significant contribution in the detailed elaboration of the adjustment-cum systemic reform in 1989. More importantly, collaboration with the Fund could not have continued without the Polish genuine commitment to the reform. However, once this commitment had been officially questioned, even if only by shifting rather than removing anti-inflationary target, the government's room to maneuver decreased considerably.

In February 1993, Osiatyński in his response in the *Sejm* to allegations of accepting the dictates of the IMF stated that if the restrictive budget for 1993 was an expression of any kind of dictate, then it was only the dictate of harsh reality – of production, prices, money supply and so on.[539] It is worth to juxtapose these words with the opinion of the previous prime minister on the need to pursue tough financial policies. In Jan Olszewski's view, fiscal restraint was not enforced by domestic problems. He identified the main obstacle to achieving his policy goals in the following words: "Only one problem kept recurring: the International Monetary Fund - the need to rebuild relations with it and [thereby] restore economic importance of the country". In a stark contrast to this, Osiatyński – on another occasion – emphasized his government's will and ability to run free economic policy, stating, "I didn't need to be pushed [by the IMF]." As the key argument, the minister pointed to the fact that the size of the required deficit target was first determined by the government and presented to the Fund for approval later on.[540]

However, that was not true. Olszewski's assessment better reflected real opportunities and constraints in running economic policies in the period in question. First of all, as I mentioned earlier, Osiatyński's stance clearly evolved over time. In July 1992, he was skeptical to the possibility of adopting a 5-percent GDP deficit of 65.5 billion złoty and assumed a 9.5-percent of GDP deficit of 100 billion złoty. In August, however, he agreed to adopt a 7-

[538] For example, in his interview with Randall Stone, Balcerowicz assured that Poles were partners with the IMF [Stone, R. *Lending Credibility*, p. 102]; Elsewhere, he emphasized the auxiliary role of the IMF to the Polish reformers in devising the program [*Successes of the International Monetary Fund*, p. 63].
[539] *J. Osiatyński's speech in the Sejm*, February 12, 1993.
[540] Ibid.

percent GDP target of 81 trillion zloty. Secondly, more effective in disciplining the government than the "dictate of harsh reality" was the pressure exerted by the IMF.

In January and February 1993, representatives of the Fund recalled the government that the mission would not agree to a deficit lower than 5 percent of GDP, and that a change of the deficit would mean renegotiating other macroeconomic indicators, which would require subsequent rounds of laborious negotiations.[541] More importantly, the "symbolic significance of the 5 percent" to the Fund is proved in the history of the budget negotiations held by the Fund and Poland. After 1989, the IMF made considerable concessions on deficit several times: first, it was reluctantly accepted drawing on the budget surplus in the second half of 1990, which resulted in the decrease form 3.5 percent surplus of June 1990 to 1 percent in early 1991.[542] In May 1991, the mission gave consent to the deficit being raised from 0.5 to 3.5 percent of GDP. In 1992, the deficit target was allowed to rise to 4.5 percent, and then to 5.5 percent of GDP. Lastly, the Fund's great flexibility towards the government is evidenced by its consent to a deficit of 8 percent of GDP in 1992, yet on condition that in the fourth quarter of 1992 reforms ensuring a 5-percent GDP deficit would be implemented. This shows that the Polish government consistently strived to increase the deficit level and it would most likely continue to do so if not for the disciplinary role of the Fund. It was the Fund that set in the second half of 1992 the limit of 5 percent of GDP for 1993 and considered it "inviolable"[543] from then on, even if achieving that target had to be delayed.

[541] „*Cierpliwość wierzycieli wystawiona na próbę*", Życie Warszawy, February 8, 1993. [*Bankers' patience put to the test* in the newspaper „Life of Warsaw"].
[542] According to Gomułka, at that time Polish negotiators told the IMF that since Poland fulfilled the performance criteria, the Fund should not be concerned with anything else.
[543] *Cierpliwość wierzycieli wystawiona na próbę...*

Chapter VII. ‘The march consensus’ in danger

1. Fiscal adjustment

Below I present how did the implementation of arrangement of the ‘March consensus’ in 1993 look like. Depending on the fulfilment of the performance criteria set in the stand-by arrangement in March 1993, the Executive Board was expected to issue an opinion in December on the implementation of the IMF program, which was to determine the fate of the second tranche of debt reduction. First, I present the effects of fiscal adjustment, and then I focus on the aspect of maintaining net international reserves at an adequate level, which was of key importance for debt reduction. Although the government’s implementation of the fiscal adjustment-cum structural reform was impeccable, the issue of reserves became subject of a short dispute between the government and the IMF mission. I show below that in Poland’s view, the problem of reserves became the only problem of economic policy in the second half of 1993 and was soon solved in order to receive the second tranche in April 1994.

The instruments and objectives of the fiscal adjustment-cum-structural reform envisaged for the period 1992-1993, were formulated by the staff mission in its concluding statement in February 1992. On the structural aspect, there was a need for a much-reinforced effort to improve public finances on a lasting basis through broadening the tax base and strengthening tax administration, improving expenditure management and reforming social insurance programs. Implemented properly, these measures would allow for the expansion in public infrastructural investments that was required by the long-term growth of the economy.[544]

The fiscal stabilization operation conducted in 1993 satisfied all conditions set by the Fund with the government as part of the ‘consensus’ and specified in November by Michael Deppler. The revenue base was strengthened through the introduction of a value-added tax (VAT) in January 1993 as envisaged, and improvements in tax administration were achieved, among others, by the introduction of banderoles on imported tobacco and alcohol. As far as the expenditure side is concerned, budget transfers to social insurance funds were restricted as

[544] *Concluding Statement of Mission in Warsaw*, May 12, 1992, „Polish Transformation. Documents..., 1991-1993”, p. 459-469.

planned.[545] All these attainments were confirmed by the Fund mission in a joint Letter of Intent of the IMF and the government of September 1993.[546]

The Fund's requirement that fiscal adjustment should provide for a suitable 'reserve' if assumptions in the government's draft budget proved overly optimistic again was also satisfied. In September 1993, the Fund mission confirmed that the target for keeping current budgetary expenditures within 45 percent of the annual total was met in the first half of the year.[547] As regards structural reforms other than those connected to fiscal adjustment, the mass privatization was proceeding as planned, the finalization of the bank and enterprise restructuring project under the auspices of the World Bank was under way, and the functioning of the safety net was being improved.[548] As a result, the 1993 deficit turned out to be much lower than anticipated, i.e. it amounted to 2.8 percent of GDP against the target of 5 percent of GDP.

2. How to meet the reserve target

The government met the conditions of the March consensus regarding fiscal adjustment. Hence, the risk of a more serious budget collapse decreased substantially, since structural barriers for uncontrolled deficit growth were successfully established. However, what was the case with foreign reserve assets that constituted such an important element of the consensus? Although for the international financial community, the budget was a measure of Poland's 'European' credibility understood as the determination in implementing the rapid transition to a free-market system, the state of foreign reserve assets specified the government's determination to rebuild Poland's payment capacity and was a measure of its financial credibility.

Furthermore, in view of the Paris Club countries that overfinanced Poland's financing needs in 1991-1993, the matter of sufficiently high reserves was all the more important, since it determined the very success of the debt reduction operation. It should be stressed that the Agreed Minute signed in 1991 provided for a "backloaded amortization schedule" that entailed increasing debt service payments in the second half of the decade. This was a

[545] Confirmed in the author's conversations with S. Gomułka and S. Kawalec.
[546] *Letter of Intent*, September 2, 1993, „Polish Transformation. Documents...., 1991-1993", p.837-843.
[547] Ibid, p. 839.
[548] Ibid.

consequence of the Paris Club's consent to the IMF's proposal to replace flat payments with graduated payments after 1994. At the same time, the agreement of 1991 meant "substantial front-loading of the cash flow assistance" granted to Poland in the period 1991-1993, to prepare the ground for gradually increasing payments after 1994**.** In case it turned out that at the time when the second tranche was planned to be triggered, the government squandered that substantial assistance, the granting of the second tranche of debt reduction would be put into question.

The Polish government considered it necessary that this front-loaded financial assistance was maintained, and the Fund agreed. Both parties, however, proposed different measures for preserving reserves. I try to prove that while the Fund intended to maintain the restrictive financial policy, the government was focused on improving trade balance to ensure proper level of reserves for the time when the second tranche of debt reduction was to be granted.

As Deppler noticed in his mid-year memo to the Managing Director, economic performance was broadly in line with expectations under the program, with the sole exception of trade balance, which was weaker than had been foreseen. This, in turn, put reserve developments at risk and for that very reason, the mission would have to re-evaluate the financial program for the second half of the year to ensure that it was sufficiently tight to meet the reserve objectives in view of rising foreign debt service payments in the future.[549]

More importantly, the Polish government too saw trade deterioration in the form of import surge and poor performance of exports to be the main issue in the mid-1993. Allen informed Deppler of talks with members of the government who drew attention to fairly strong elements of balance-of-payments, such as private transfers and the purchase of foreign exchange by banks from 'exchange offices' (pol. *kantor*). Nevertheless, they pointed to the need for a stronger balance-of-payments if Poland was to be able to service its debt in the years to come.[550]

As can be seen, the government and the IMF were concerned not that much about poor trade performance, as about the danger of prospective shortfall in foreign reserves, which would decrease the government's capacity to meet debt payments in the medium term, which was highly important for the Paris Club. Although both parties agreed with this 'diagnosis', there were many differences when it came to the matter of 'treatment'. Already in November 1992,

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[549] IMF Archives, Poland-First Review of SBA 1993, *Briefing Paper for SBA Review Mission*, M. Deppler to the MD, June 25, 1993.
[550] IMF Archives, Poland 1993, *Poland - Or What I Did on my Summer Holiday*, M. Allen to M. Deppler, June 7, 1993.

the mission feared that in the case of shrinking reserves, the authorities may resort to devaluation instead of rising interest rates.[551] Interestingly, in this matter, the IMF counted on assistance of the NBP that showed its commitment to strict monetary policy openly and repeatedly in 1992. The matter of path towards rebuilding reserves was the sole sticking point between the government and the IMF mission in the mid-1993.

More precisely, it was the choice between devaluation and rising interest rates that became the main focus of the dispute between the mission and the government when it came to solving the trade deterioration issue. The government's inclination was to focus on exchange rate rather than interest rates as a means to address the deterioration in current account position[552]. The mission, on the other hand, argued that the deterioration in the external position was not due to a decline in Polish competitiveness (given the current recession in Western Europe) and that the exchange rate adjustment should not be applied as a solution to the problem.

Instead, the Fund pushed for an adjustment in interest rates. In its view, the problem of declining reserves was a result of loosening of monetary conditions in the first half of the year. In May 1993, interest rates were barely positive at the inflation of 36 percent. As a result, imports accelerated and demand for treasury bills and bank deposits fell. In the mission's view, these were troubling trends given the government's financing needs in the near future[553]. It was the reversal of these trends that the IMF called for in order to secure continued financing for debt service. On the other hand, the government opted for devaluation as a traditional means for improving trade balance because it ensured more rapid effect in the form of increased reserves of the NBP.

In late June, the IMF declared a compromise solution in a briefing paper, which was later approved by Poland. In order to ensure meeting reserve objectives, the mission took the position that at a minimum and for the time being, a reduction in interest rates should not be undertaken and on this very condition the mission agreed to devaluate *zloty*.[554] The Fund's interest was not as much to suppress devaluation, but to stop further relaxation of the monetary program. The Letter of Intent of the Polish government of September 1993 confirmed that the above agreement was implemented in practice. The authorities committed themselves in the letter to retain the financial policies, as expected by the IMF, anchored in

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[551] IMF Archives, Correspondence and Memos, April-September 1992, File 2-1, *Poland: Back-to-Office-Report,* M. Deppler to the MD, November 24, 1992.
[552] IMF Archives, Poland-First Review of SBA 1993. *Poland-Draft brief for first review of SBA*, M.Guitian to M. Deppler, June 23, 1993.
[553] Ibid.
[554] IMF Archives [...], *Briefing Paper for SBA Review Mission*, M. Deppler to the MD, June 25, 1993.

the deficit target of 5 percent of GDP (81 trillion zloty) in 1993. On the other hand, the government complemented those policies with a moderate devaluation designed to strengthen reserves.[555]

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With the year 1993, Poland completed the first and the most difficult stage of systemic transformation referred to by the IMF as a "balanced growth with reduced inflation".[556] From the fourth quarter of 1992 until the end of 1993, transitional and structural arrangements were implemented to permanently stabilize the fiscal situation: PIT and VAT taxes were introduced (in January 1992 and in January 1993, respectively), tax collection was improved, the tax base was broadened, the pension and social insurance systems were reformed, and import surcharge was introduced. Moreover, bank capitalization was finalized, and the mass privatization program was approved by the *Sejm* on April 30, 1993. Hence, disciplinary mechanisms applied in budget policy were combined with the structural reform, thus ending the first and the most demanding stage of the systemic transformation.

The fact that the Polish economy was one the best performers among the economies undergoing transition was stressed by most Executive Directors during the review under the IMF stand-by arrangement in September 1993. Executive Director John M. Abbott from the United States openly stated that Poland had already completed the transformation in the form of macroeconomic stabilization. Referring (as did other Directors) to the second year of economic growth, permanent decrease of inflation from 1990, declining fiscal deficit and disciplined monetary policy, he viewed it as persuasive evidence demonstrating that Poland "turned the corner from transition to a stage at which growth has the potential to be self-sustaining." And it was the maintenance of this balanced growth that he saw as the primary objective to be attained by subsequent governments in Poland.[557]

Below I present the two most important consequences of the structural adjustment made in 1993. Firstly, one of the priority objectives of the Polish government was to reduce debt to private banks (13.3 billion dollars). The fulfilment of the conditions set in the 'March consensus' by the Polish government in 1993 made it substantially closer to signing an agreement with the Paris Club on the second tranche. Yet, before that took place, Polish

[555] *Letter of Intent*, September 1993: On August 27, 1993, the NBP devalued the zloty by 8 percent with a view to secure "a lasting improvement in competitiveness."
[556] IMF Archives, Poland-First Review of SBA 1993. *Republic of Poland - Review under Stand-By Arrangement, and Review of External Financing*, September 17, 1993.
[557] Ibid.

authorities had to gain private banks' assurance that the parity of treatment principle would be respected so that the scale of Poland's debt relief was comparable to the scale of the relief granted by the Paris Club. Importantly, without such an assurance, official creditors could not proceed with the second tranche.

Secondly, the government adopted a more assertive stance in relations with the Fund. By finishing the first stage of transformation, Poland gained a greater bargaining power in relations with Western financial institutions. Hence, the government demanded from the Fund clear support in negotiations on debt reduction with the London Club. At some point, the Polish authorities even made continuation of the structural reform (understood as proceeding with privatization and other structural and institutional changes) dependent on that support. Thus, the 'conditioning' officially established in April 1991, which had served as the grounds for cooperation in trilateral relations (the IMF-the Paris Club-the Polish government), was temporarily reversed.

3. Private debt reduction as a priority

During the meeting of the Executive Board in September, attention was repeatedly drawn to the necessity to solve the stalemate in relations between the government and private banks. According to Executive Directors, the Paris Club-debt relief was not sufficient and a longer-sighted solution had to be granted, because the debt overhang remained a considerable constrain to Poland's external viability.[558]

The stalemate in relations with banks continued since the end of 1989, when the Mazowiecki government decided to re-establish relations with official governments with a detriment to those with Western commercial banks. It should be stressed that private banks did not accept the arrangements of the Paris Club Agreement under which a 30-percent reduction was granted, and further 20 percent were made dependent on the implementation of the IMF program. Relations with banks deteriorated substantially when in February 1993, the government "announced that beginning from May, it would pay only 10 percent of interest falling due on medium-and long-term debt.[559] The banks' reaction was that the proposed level

[558] Ibid.
[559] *Report on the activities of the Government Plenipotentiary for debt negotiations with commercial banks in the years 1993-1994*. „Polish Transformation. Documents..., 1991-1993", p. 885.

of interest payments was insufficient and that this aspect would need to be negotiated before progress could be made in the discussions.

The role of private banks, holding 13 billion dollars of the Polish debt, was considered crucial in eliminating the drag of external debt on the expansion of the Polish economy. As envisaged in the 1991 Paris Club agreement, Poland's other creditors were required to a comparable scale of debt relief to that granted by the governments. However, Poland had still not concluded an agreement with the commercial banks. As one of the Directors put it, “We do not believe that it would be equitable for the commercial banks now to reap the benefits of both Paris Club debt reduction and Polish reform efforts without providing comparable debt reduction of their own.”[560]

The matter of private debt reduction became one of the most urgent matters for the Polish government in 1993 due to several reasons. Firstly, as already mentioned, the Paris Club’s consent to the second tranche depended on the declaration made by banks regarding the observance of the comparable treatment principle.[561] In this sense, the agreement of 1991 was assumed to be a double success for Poland, for not only did it reduce the official debt, but also ‘forced’ private banks to grant a comparable reduction. However, banks did not approve of Poland’s agreement with Western governments and considered it an unacceptable pressure on them. In August 1993, Prime Minister Hanna Suchocka complained to the Fund’s Managing Director that the negotiations with commercial banks were unlikely to bring acceptable result in 1993 without the IMF assistance.[562]

Secondly, reaching a settlement with the London Club was necessary to restore both private capital flows and long-awaited investors’ confidence badly needed to support the development of the private sector. Thirdly, and most importantly, completion of the transformation of the Polish economy, its privatization and the integration of Poland into the international financial community all depended on the settlement with the London Club.[563] Hence, at the turn of 1994, the attainment of the strategic objective of the post-1989 reform, i.e. Poland’s sustained external viability, depended on private debt reduction.

The situation was not improved by the Fund’s hesitance in granting assistance to the government. The Fund itself adopted an ambiguous approach to the inviolability of the

[560] IMF Archives, Poland-First Review of SBA 1993...
[561] IMF Archives, Poland 1993. *Michel Camdessus’ letter to Hanna Suchocka*, October 1, 1993.
[562]IMF Archives, Poland 1993. *The letter of Prime Minister Hanna Suchocka to the Managing Director*, August 27, 1993.
[563] Ibid.

comparable treatment principle and, consequently, did not exert pressure on Western banks regarding reduction, which was expected by Poland. Thus, the IMF questioned the principles underlying the ‘March consensus’ of 1992, which made reduction of debt to the Paris Club dependent on the implementation of the stabilization-cum structural adjustment by the end of 1993.

In June, the Vice Minister of Finance Stefan Kawalec in a conversation with Allen was keen for the Fund to endorse the statement of General Principles agreed with the banks, which implied that there had to be comparability of treatment. In response, Allen “expressed some skepticism” and replied that the government could not hide behind the Fund and the Paris Club, and that it was important for Poland and the banks to negotiate intensively with each other.[564] Poland could be taken aback by such an approach to this matter. In line with the March consensus, by promising Poland to receive the second tranche of debt reduction as scheduled, the IMF in a way took on the responsibility to ensure the comparability principle be observed by banks. At that time, not only did the Fund call the government to negotiate with the London Club without any ‘back up’ from the IMF or Western governments, but also emphasized time pressure, stating that the government did not have much time as the stand-by arrangement would be expiring pretty soon.[565] Thus, it turned out that the implementation of the reform alone would not ensure the second tranche of debt reduction to Poland. Hence, the government elevated the issue of the agreement with banks to the most urgent priorities.

Relations with the Fund continued to deteriorate. In August, the Vice Minister of Finance Krzysztof Krowacki, the key negotiator in negotiations with the London Club, wrote in his letter to Michael Deppler that he was very surprised and disappointed of the Fund’s stance on Poland’s efforts to obtain reduction from the London Club. Instead of being supportive of Poland's efforts, the Fund, according to Krowacki, undermined Poland's ability to negotiate the most appropriate debt and debt service reduction agreement, particularly at such crucial juncture in the negotiations.[566] Not only did the Fund trivialize the importance put by the government “on realistic cash flow and cost constraints to implement a sustainable deal, but virtually ignored the relevance of comparability with the Paris Club as an important objective.”[567] At some other time, Mark Allen clearly stated to the government it should not

[564] IMF Archives [...], *Poland - Or What I Did on my Summer Holiday*, M. Allen to M. Deppler June 7, 1993.
[565] Ibid.
[566]IMF Archives [...], *The letter of K. Krowacki to J. Stokley*, January 18, 1993.
[567] Ibid.

stick so closely to the comparable treatment principle in negotiations with the London Club.[568] As a result, the Polish authorities were more and more frustrated.

4. Polish blackmail

The government could feel victimized by the IMF and the Paris Club. First, it put an enormous effort in convincing the Fund to conclude the SBA in a way that would allow it to complete the implementation of the program by the original term of the second tranche. Then, it implemented the economic program as planned with the IMF. And then, after all this, it turned out that the path towards full reduction of the official debt was blocked by private banks, and the IMF was not eager to give Poland a helping hand.

In this situation, the government decided to play tough. Since the IMF did not fulfil the arrangements of the March consensus, Polish Prime Minister Hanna Suchocka in her letter to the Managing Director claimed: “at this stage, the continuance of the government prepared to make the budgetary sacrifices necessary for an acceptable debt service reduction agreement after years without progress cannot be assured.”[569] In short, the March consensus could be presented as an allocation of tasks, in which Poland was to continue its course towards the rapid transition reform, and the IMF was to ensure full and timely reduction of the official debt. However, in the meantime it was necessary to convince private banks to observe the principle of comparable treatment, as it was required under the Paris Club agreement. Nonetheless, even when considering the role of bilateral negotiations between banks and the Polish government as crucial, the intervention of the IMF was essential here. Meanwhile, as Suchocka stated, there had been no progress in negotiations on debt reduction with banks for years.

It should be emphasized that Suchocka pointed in her letter to the correlation between further restrictive fiscal policy and the receiving of debt reduction, which she referred to further in the letter as a form of compensation for the Polish society. Since the prospect of debt reduction was becoming more and more distant in time, the government resorted to a threat that it would abandon the path of the rapid transition to a free market system. Moreover,

[568] IMF Archives, Correspondence and Memos, Oct-Dec 1992, File 3.
[569] IMF Archives, Poland 1993. *The letter of Prime Minister Hanna Suchocka to the Managing Director*, August 27, 1993.

Suchocka stressed that Poland fully deserved debt reduction, as it "made every effort to achieve the conditions required to effect the second stage of debt reduction, scheduled for April 1994". One month later, this was confirmed by Executive Directors, according to whom all the performance criteria of the program for the first quarter of 1993 were met.[570] Hence, Poland was on the best way to obtain a positive opinion of the Board also in late December, which, in line with the arrangements of 1991, determined whether the second tranche would be triggered.

Apart from resorting to the threat of abandoning the current path of reform, Suchocka at the end of her letter to Camdessus mentioned the most strategic objective of the Polish reform that was so significant to Western governments and that from the very beginning was inseparably linked to debt reduction. The Prime Minister asked for "understanding and assistance at this important juncture in promoting Poland's efforts to be included once more among the world's democratic market economies."[571] It was the most strategic objective of the reform that was continuously driving the reformers from late 1989. Poland was expected to join democratic market economies as soon as possible and its action aimed at this result determined its credibility during the years of the reform. In turn, debt reduction was to serve as a culmination of the rapid transition reform and a guarantee that its results would be permanent.

More importantly, Suchocka referred to the 'regional' argument for the debt reduction, claiming: "The advanced stage of economic transformation achieved by Poland gives the question of ultimate success in this effort particular importance for all economies in the process of transformation." As I tried to show in the thesis, the argument on the regional significance of the Polish reform played the decisive role in the IMF strategy towards Poland. The regional aspect of the Polish reform was first stressed already in September 1989. At that time, Camdessus said "We must succeed" when the proper pace, depth and structure of the Polish reform and financial support in the form of debt reduction was discussed at the private meeting with representatives of the IMF, the World Bank and US administration. The validity of this argument was confirmed in late 1993 by the members of the Fund's Executive Board, one of whom stated: "Poland should be a leading light to countries currently in transition, and, no doubt, the country's experience does provide encouraging road maps."[572]

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[570]IMF Archives, Poland-First Review of SBA 1993...
[571] Ibid.
[572] Ibid.

In the context of the entire letter, the Polish Prime Minister's reference to the argument on the regional implications of abandoning the reform in Poland explained the negative consequences this could have for the Fund. After long years, when subsequent governments "made every effort" to continue the reform and followed the rules set with the IMF and the Paris Club, the Polish government, on the final straight in the implementation of its unique reform, was left by the IMF alone with its debt reduction problem. Thus, the lesson the countries of the region would take from this model of cooperation with the Fund was clear: Poland did everything to confirm its credibility, while the IMF withheld the promised support at the crucial juncture.

The possibility for the Polish government to reverse the reform/reduction conditioning that was binding from the day the March consensus was concluded in 1992, was also evidenced in a report of the Deputy Managing Director of the IMF of late 1993. In a report from a meeting with representatives of the new Polish government, Richard Erb claimed that the new Polish authorities pointed out that "early progress in negotiations with the banks was critical as it would help underpin a prudent policy approach of the new government."[573] The government, according to Erb, stressed also that the agreement with the London Club needed to be "realistic" due to the rapidly mounting payments to Paris Club creditors in the years ahead. Although the threat that the transformation reform would be abandoned was certainly not expressed here explicitly, there was a clear suggestion that the progress with banks was the best guarantee of continuity in prudent financial policies carried out by the new government. Otherwise, the government might lack motivation.

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From 1989, debt reduction was made implicitly linked to the radical variant of the economic reform. The need for the reduction was justified not only by the scale of the adjustment effort and the size of the financing gap that would form as a result, but also by political concerns as was indicated during the September meeting in the office of the Managing Director. At the end of the year, when the Polish government decided on the rapid transition to a free market Western-like system, the correlation between the reform and debt reduction was already evident and officially stated by both Poland and the IMF. I tried to show this by presenting three types of arguments for reduction that were formulated at the turn of 1990. After the agreement was made with the Paris Club in April 1991, further debt reduction was officially

[573] IMF Archives, Poland 1993. *Report by the Deputy Managing Director*, Richard Erb. November 24, 1993.

dependent on whether the macroeconomic stabilization-cum-structural adjustment launched in 1989 was continued.

Due to highly difficult political situation that already in mid-1991 convinced the government to move away from the EFF agreement, in March 1992, the Polish government and the IMF had to reestablish the consensus on the reduction/reform correlation. From then on, financial assistance from the West was dependent on continuous readiness of the Polish authorities to confirm the '*European'* credibility of Poland understood as a strive for completing the rapid transition to a free market economy. This credibility determined whether and when Poland would gain *financial* credibility, which was determined primarily by whether it was granted foreign debt reduction. The correlation between these two types of credibility was confirmed by the informal March consensus.

However, when in 1993, Poland came back on the path of the reform of 1989 in a dynamic and spectacular way, it turned out that its effort was not properly appreciated in the West. Since the provisions of the March consensus were violated by the IMF, the Polish Prime Minister threatened that adequate measures would be taken by the Polish government, too - namely, the process of building democratic capitalism would be abandoned or delayed until the debt reduction process is unblocked. This would mean the government changed the hierarchy of priorities by putting financial credibility *over* the 'european' credibility. Thus, Poland would demonstrate its lack of faith in cooperation with the West at the time when almost all countries in the region were undergoing systemic transformation under the auspices of Western financial institutions. Poland's move would strongly undermine credibility of the IMF and Western governments that from 1989 saw Poland as the pioneer and path-setting country for the others in the region to follow, who were to convince them to adopt bold market-oriented reforms. Prime Minister Suchocka's letter to the Managing Director of the IMF is a proof that the matter of obtaining full debt reduction was a priority issue for Poland at the time, meaning that, at that particular moment, it was more important than the continuation of the rapid transition reform.

Poland's pressure brought quick results. In the fall of 1993, the Managing Director unambiguously expressed his support of the authorities' plans and assured them that the Fund would do everything in its power to help them quickly conclude a debt reduction agreement with the private banks that would meet the comparability criteria stipulated by the Paris Club as necessary for completing debt reduction.[574] To this end, the Fund staff would 'objectively' point out to commercial creditors pressures in Poland's balance-of-payments in the medium and long term. The Managing Director confirmed his intent to help the government by turning to the new government with the words "you can count on us" in reference to the pressure that the Fund could exert in the area of talks with commercial banks.[575]

One month later, the IMF officially repeated that it would defend the principle of comparable treatment in negotiations with the London Club. Deputy Managing Director Richard Erb in two-day negotiations with the new government ensured it that the IMF would explain to the London Club the present economic situation in Poland and the importance of concluding an agreement with Poland. The government was also told it would receive information on Erb's planned meeting with the London Club representatives in Frankfurt to inform them that the IMF shared the Polish government's opinion regarding terms of an agreement with banks: it should be comparable to those of the Paris Club deal, which gave a 50-percent debt reduction on a 33-billion-dollar debt.[576]

[574] IMF Archives [...], *Meeting with the Managing Director*, September 29, 1993.
[575] Ibid.
[576] *Nowa Europa* [New Europe], November 18, 1993.

Chapter VIII. “The last occasion” for Western creditors

By pressuring private banks, the IMF returned to the fulfilment of provisions of the March consensus. In March 1994, the London Club obliged itself to respect the principle of comparable treatment in the form of a Head of Terms, which eliminated the last obstacle on the way towards the second tranche of debt reduction from the Paris Club, which was granted as planned in April 1994. However, private debt reduction was still uncertain. Although the Head of Terms specified conditions for the reduction, it gave no guarantee. In this chapter I describe what the final stage of the fulfilment of the informal ‘debt reduction for rapid reform’ conditioning looked like, which was a major driving force of the reform process in the period 1990-1994. The main objective of the chapter is to prove that as in the previous years, the issue of debt reduction was considered by the IMF both as a stick and a carrot to make the government pursue the rapid transition reform also at the last stage.

In the situation where the second tranche was already granted, it proved quite troublesome for the IMF to find a way for mobilizing the Polish authorities to continue the reform, which at this stage required mainly privatization as the culmination of institutional changes, obviously assuming that a stable level of inflation was maintained. The very existence of the problem alone proves that the issue of debt reduction was treated by the IMF as the key guarantee that the rapid transition reform would not be abandoned by the Polish authorities. This was the substance of the March consensus.

The former model of cooperation between Poland and the IMF was questioned in 1993 due to the emergence of two new factors. First, the Fund feared that upon the granting of the second tranche of debt reduction, a way to private debt reduction would become open and, hence, the government would lose motivation to continue the rapid transition. For this reason, it sought a different stimulus for Poland that would ensure that the economic program was implemented as the Fund intended. This guarantee was found in the form of additional resources for financing private debt reduction operation, since it knew that the government would be unable to mobilize all the resources due to objections from the NBP. Indeed, it was the Central Bank that proved the Fund’s ally in effective disciplining of the government at the time.

Secondly, the Fund perceived the fact that Poland’s commitment to economic transition was considerably weakened by the new political situation resulting from the victory (for the first time since 1989) of a coalition of post-communist parties in October 1993. The outcome of the Polish election was enthusiastically received by neither the IMF nor the US administration. National Security Advisor to the US President Anthony Lake described the new situation in Poland as disturbing. Firstly, this referred to the consequences of election for "the supporters of reform elsewhere in the region."[577] Secondly, he feared that the cooperation between the IMF and the newly elected government would deteriorate, as the latter came to power under the slogan of giving society the long-awaited relief after years of austerity.

Mark Allen touched on this subject by openly claiming that the outcome of the election was a direct result of the Fund's inspired policies and that the Fund had to come up with a way to approach these type of allegations that could come from the new government.[578] In his 'Back-to-Office Report on the Political Situation' written in October he indicated what were the main factors that shaped the stance of the Fund on the new government. After the change of authorities, he saw an opportunity for continuing the rapid transition reform in an alliance with the NBP. President of the National Bank Hanna Gronkiewicz-Waltz and Deputy President Witold Kozinski clearly expressed to the Fund that they were determined to maintain the current policies ensuring that inflation continued to fall, and that the amount of the Bank's finance for the government would be less than the previous year.[579]

Hence, the Fund could count on the NBP in case the government pressured it to loosen monetary policy. Still, the management of the Central Bank also perceived the IMF as a natural ally in the dispute with the government on economic policy that had been growing already since 1992. This was indicated by Mark Allen in a report on his conversation with Koziński: "He talked in a way that I had not heard him before of the role of the Fund as a partner in the NBP's discussions with the Ministry of Finance."[580] The NBP in its firm stance on monetary policy was also supported by the Presidential Palace, where Andrzej Olechowski, the former Minister of Finance and the co-author of the 'March consensus', acted as the key economic adviser to Lech Wałęsa.

Assuming that its program and economic progress in Poland would stand or fall on the strength of monetary policy, the Fund decided to fully support the strict monetary policy promoted by the NBP. Therefore, the Fund wanted to be prepared to defend the president of

[577] IMF Archives, Poland 1993. *Mr, Lake's Comments on Poland*, October 14, 1993.
[578] Ibid.
[579] Ibid.
[580] IMF Archives [...], *Poland - Back-to-Office Report on the Political Situation*, M.Allen to M. Deppler, October 21, 1993.

the NBP in case of attacks on her made by the government to subject the NBP policy to its own objectives. Allen stated that in such case, “it needs to be clear that it will not avail them much, as we and the outside world will not accept the resulting policies.” These words indicate that the two main pillars of the IMF’s policy towards the government were the alliance between the Fund and the NBP and foreign financial support. In particular, the last part of the sentence suggests what was the fundamental catalyst of the reform until that time, namely, the authorities’ need for general respectability abroad and the related external assistance, notably debt reduction.

1. Debt reduction as the main drive for the follow-on SBA

As I have proved in the first part of the thesis, Massimo Russo was one of the authors of the Western strategy of financial assistance to Poland, which consisted in restraining Western governments from granting of urgent financial help to Poland and waiting for the democratic government to form in Poland, which would then allow the strategic interests of the IMF to be aligned with those of the Paris Club and the Polish government. In February 1994, i.e. two months before the planned termination of the stand-by agreement concluded in March 1993, Russo submitted another original proposal to the Managing Director, though the stake was not that high as five years earlier. That time, he proposed that the current cooperation with the Polish government be reorganized in a way that would ensure continuation of prudent economic policies. This was to be achieved by means of financial enhancements for the imminent private debt reduction.

Russo pointed to the fact that on the basis of economic performance to date, the government would be in a position to purchase about 500 million dollars from the IMF, since it had refrained from drawing under the current Stand-By arrangement so as to secure resources to finance debt reduction agreement with the London Club. However, Russo recalled that releasing this money was conditioned on the completion of the review by the Executive Board.[581] He then went on to indicate that the politically-rooted uncertainties regarding the future course of economic policies carried the risk of delaying the conclusion of a prospective follow-on stand-by arrangement. To avoid this, the staff should consider extending the current

[581] IMF Archives, Poland-Second Review of SBA 1994. *Poland - An Update*, M. Russo to the MD, February 14, 1994.

stand-by arrangement until mid-year. The extension of the current program would make the granting of these 500 million dollars to Poland dependent on the completion of the program, and thus ensure natural linkage with the new SBA, which was tied to a London Club deal.

The Fund feared that once the current SBA expired in March 1994, releasing set-asides could discourage the government from continuing the current course of the reform. For that very reason, extending the current SBA would mean making the issuance of set-asides conditioned on the completion of the review by the Executive Board at the end of the extended program. In the meantime, these resources would be still desired by the government and would discipline it in economic policy. Moreover, an extended SBA would ensure that the set-asides were maintained (instead of being immediately spent by the government) while a new follow-on Stand-By arrangement was negotiated.[582]

The most important goal for the IMF was that this maneuver would provide some control over the implementation of financial policies in the months ahead. Ensuring control over the government's economic policy in the form of extending the current SBA would reduce "the risk that, once the funds from the Paris Club and the IMF have been obtained, policies would be relaxed."[583] This sentence provides hard evidence that the IMF was fully aware that it was the prospect of debt reduction that so far had played the key role in disciplining economic policy. From 1990 onwards, no factor mobilized the authorities to continue the rapid transition reform more effectively than the willingness to obtain debt relief. Unsurprisingly then, the Fund wanted to prolong this exceptionally favorable situation in its cooperation with Poland.

Camdessus was informed of the difficult political situation in Poland by Deppler and Russo in February and in March, respectively. As the situation worsened further, their views on further cooperation with the government in 1994 cleared up. They both believed that due to political difficulties, the "reform agenda is on hold" and claimed that the new SBA "could be instrumental in crystallizing Government decisions in support of certain necessary steps in the reform proces."[584] Moreover, they both stressed that the Polish authorities considered the program with the IMF as a means for arriving at a settlement with the London Club. Therefore, it was the willingness to obtain private debt reduction that made the government want to continue cooperation with the IMF, and the latter saw this readiness of the Polish

[582] Ibid.
[583] Ibid.
[584] IMF Archives [...], *Poland-Use of Fund Resources and Article IV Consultation*, M. Russo to the Acting MD, February 23, 1994.

government to cooperate as an occasion for formulating the key elements of the final stage of the transformation reform. Thus, debt reduction seemed once again the key factor that allowed the reform momentum to be maintained.

This was particularly emphasized by Russo, who claimed that the Fund had to "strongly support the Government in its desire for early agreement on a new SBA that would permit it to complete its negotiations with the London Club."[585] More importantly, he emphasized that "this SBA may be the last occasion for some time when external creditors may have some direct influence on economic policies in Poland."[586] These two facts - the London Club agreement as the government's key argument for the follow-on SBA and the awareness of the last chance for making a direct impact on the continuance of the reform thanks to the debt reduction issue – required "careful balancing" on the part of the Fund, so that the advantage of granting financial support for debt reduction that the Fund still had in negotiations with the government was used in an optimum way for the last time.

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In September 1994, The European Department of the IMF was considering an option to make the financing of the private debt correlated with specific declarations of the government on the pace and form of privatization as the final key element of the rapid transition process. First, Deppler referred to the serious delay in the privatization process to justify his proposal for the government that "for the Board to be able to consider the request for Fund support for the DDSR [Debt and Debt Service Reduction] operation, it would be highly desirable for the authorities to be able to indicate their revised privatization plans and a timetable for implementation, which the staff would judge to be acceptable."[587] One week later, only 12 days before Poland was granted reduction by the London Club, Russo actually informed the government during his visit in Warsaw that if it expected the IMF to take part in financing DDSR operation, the government had to give an assurance that privatization would proceed as foreseen.[588]

However, in the very same report, Deppler indicated disadvantages related to the Fund's demands that privatization policies be clarified prior to the DDSR operation. Firstly, this could delay the process of granting debt reduction to Poland, since then a positive opinion on

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[585] IMF Archives [...], *Use of Fund Resources and Article IV Consultation,* M. Russo to the MD, March 23, 1994.
[586] Ibid.
[587] IMF Archives, Poland 1994, *Poland*, M. Deppler to the MD , September 20, 1994.
[588] IMF Archives [...], *Visit of M. Russo-Summary of Meetings*, September 29, 1994.

the program could be issued by the Executive Board too late. Secondly, it could also be seen by the government as a lack of the Fund's cooperation, all the more so since the authorities implemented economic policy under the stand-by arrangement to great success.[589]

Eventually, on the request of the Managing Director, the plan to tie enhancements for the DDSR operation with a clear statement from the government to accelerate the privatization process was abandoned. There were two reasons that determined the recjection by the IMF of such an ultimatum. Firstly, privatization, a key aspect of the structural agenda, was off-track for political and not economic reasons. Secondly, the authorities met all the usual financial criteria. On this basis, Russo informed Camdessus that "Per your instructions, we have not allowed the privatization issue to jeopardize our timely support for the DDSR operation."[590] Instead, the staff demanded the government to make it clear in the Letter of Intent that developments on mass privatization remained a key concern in economic policy under the next stand-by.[591]

Even though both above-mentioned attempts of the Fund to use the debt reduction issue to ensure its interests were not put into force, they provide a better picture of the strategy adopted by the Fund towards Poland in 1989-1994. Both these proposals clearly prove that for years, the debt reduction issue was considered by the IMF the most effective instrument for pressuring the Polish government. This is confirmed primarily by the fact that on the final stage of the reform, the Fund was still forcing the argument of debt reduction. First, when the official debt reduction was already permanent[592], it wanted to make the releasing of the 500 million dollars the government was entitled to receive conditioned on the extension of the stand-by program of March 1993, since in that way it would ensure control over the prudent economic program. A few months later, just before the DDSR operation which the government deserved by its very strong financial performance, the Fund was considering making the financing of this operation conditioned on the government's clarification of mass privatization plans.

Ultimately, the IMF abandoned both these plans, as it realized that there were some limits to using the debt reduction issue as a tool for exercising one's interests. These limits had been determined earlier in the form specific arrangements under the negotiated economic program.

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[589] IMF Archives [...], *Poland*, M. Deppler to the MD, September 20, 1994.
[590] IMF Archives [...], *Brief for the Meeting with the Delegation (In Madrid),* M. Russo to the MD, October 5, 1994.
[591] Ibid.
[592] The additional 20-percent debt reduction was authorized in April 1994.

Although the Fund could theoretically force the government to fulfil its new plans, it did not do so, as it knew that good cooperation with Poland could not be determined by imposing new conditions *ex post*, i.e., during the formerly agreed program period.

Conclusion

In the conclusion to my thesis, I try to justify that the debt reduction strategy conducted by all five governments during 1989-1994 was optimal. The emphasis on debt reduction made it possible to accelerate and complete the rapid transition reform in the originally planned time. Next, I try to show the growing importance of debt reduction in light of the increasing political instability and, above all, delays in the privatization process, which from the very beginning was considered the essence of systemic transformation.

Interestingly, like in the 1980s, it was the intense 'politicization' of the debt crisis that threw Poland into the economic crisis deeper than elsewhere in the region. In the early 1990s the very same factor became Poland's prime opportunity for accelerating economic transformation. The Paris Club gave a major stimulus to the reform by way of the large debt reduction, which was a bi-product of the 'political' approaches Western Europe took toward Poland's economic crisis. After the first tranche of the debt reduction concluded in 1991, other debtors' grew resentful toward Poland, stemming from their recognition of not being in such a favorable 'political' position as Poland. Hungary was a case in point. With most of their debt owed to western financial institutions, this highly indebted country, with an impeccable debt service, could not count on a debt relief of comparable scale. The Hungarian Minister of Finance commented on the Paris Club deal: „Someone who behaves well is penalized and someone who behaves badly gets special rewards and benefits".[593] However, the side effect of Poland's peculiar position vis-a-vis official creditors was the latter's permanent pressure on governments in Poland to hold to the course of the 'rapid transition,' which boiled down to implementing the IMF programs. Nowhere else in the region did foreign debt play such a disciplinary role in economic policy. Thanks to this, macroeconomic stabilization in Poland was brought to an end relatively quickly.

Certainly, one of the basic pillars of the ultimate success of the rapid transition reform and continued cooperation between Poland and IMF was the ideological proximity of both sides. The Fund had moments when its faith in the Polish program collapsed, but these were caused by temporary political crises. The regional IMF representatives never doubted the Polish reformers' genuine willingness and commitment to the reform. In their view, Polish reformers were highly devoted to anti-inflationary policies as well as to free-market reforms[594], and their

[593] Bjork, J., *The Uses of Conditionality: Poland and the IMF*, p. 104.
[594] Mark Allen in a 1999 interview with Randall Stone: „The Poles were totally committed to their program" [Stone R., *Lending Credibility*; p. 99].

overriding goal was to build capitalist system in Poland modeled on the West. Since 1991, Polish authorities recognized that resumption of tough macroeconomic policy was unavoidable, if the transformation process was to be completed quickly. However, the pace and timing of those inevitable steps still remained an open question. They postponed implementing anti-deficit measures for more than a year. Their strong determination from 1989 grew weaker in the face of new challenges such as the widening budget deficit, economic stagnation, social problems, political instability and perturbations in the international markets.

All this contributed to the emergence of 'adjustment fatigue', which could only have been overcome by an external financial stimulus to restore macroeconomic discipline. As I tried to prove in my thesis, it was the Poles' unshakeable and continuing desire to obtain full debt reduction that eventually pushed them back on course for the rapid transition reform. The value of the debt reduction at stake after 1991 was about 12 billion dollars: the second tranche from the Paris Club amounted to 20 percent of the debt, which was 6.5 billion dollars, with a comparable debt reduction from the London Club - of about 5 billion dollars. It is worth mentioning that this amount of money was much larger in real terms in the early 1990s than it is today. Furthermore, debt reduction was so desirable, because unlike loans or debt restructuring, it was irreversible, i.e. it simply cancelled a substantial part of the debt.

Although in 1991 and 1992 the reformers were concerned about the grave future risks of maintaining the current economic developments, this by itself did not provide sufficient stimulus to act decisively. Ultimately, it was debt reduction more than any other factor that triggered and then helped maintain fiscal discipline together with institutional transformation. This is not to argue that Poland would abandon economic reform without foreign pressure, but without the lure of debt reduction, the Polish transformation would have most probably been completed much later. The IMF acted as a catalyst in that process, reminding the Poles of the Paris Club's limited patience and the remaining systemic changes to be carried out. Moreover, debt reduction was expected to establish a solid foundation for economic growth in the years to come. Thus, it not only put an end to the decade-long debt crisis but also laid macroeconomic foundations for the capitalist system in Poland.

The IMF used foreign debt as a unique and very effective tool to achieve their strategic goals. They wanted to establish Poland as a model of economic transformation for the region to encourage other countries to cooperate with the IMF. In the period from 1989-1994, this strategic interest motivated the Fund's assistance in negotiations with Western creditors and flexibility in setting programs targets. However, such a large scale of debt reduction was possible only here, and this undermined the very essence of the IMF plan. Since only in Poland had the foundations been laid for a politically-rooted large scale debt reduction further encouraging 'rapid transition', one could not expect equally spectacular reforms in other countries. It is worth to note that a radical reform launched in 1992 in Russia[595], which was of a greater strategic significance to the IMF and the West, did not translate into a financial assistance comparable to that granted to Poland[596] - much to the indignation of Jeffrey Sachs, who had previously successfully lobbied for the reduction of Polish debt and later got involved in mobilizing large-scale Western assistance for Russia.[597] This indicates that the interrelationship between debt reduction and rapid transition was specific only to Poland.

I tried to show that the radicalism of the reform in itself did not justify debt reduction. In 1990, the Polish government received financial cash-flow relief from Western governments, who suspended all payments due in 1990, i.e. for the period of macroeconomic stabilization. However, it could also be assumed that the debt service suspension was extended over 5 years, i.e. a period of full transformation. During that time, the economy, without the burden of regular repayments to creditors, would gradually recover by making economic growth sustainable, placing inflation under control, liberalizing foreign trade to the benefit of Poland and her trading partners, strengthening thus the on-going process of democratization. In short, Poland would meet the criteria for financial credibility. With one exception - it would be left with a huge debt overhang, as debt service was only suspended for the time of the reform.

The bottom line is that neither soft reform (which Western governments were willing to support in mid-1989), nor shock therapy (actually implemented in Poland) gave sufficient grounds for debt reduction. On what basis then was Poland granted such a significant debt relief? In my thesis, I tried to prove that a justification could only be provided by a reform perceived as an unprecedented rapid transition to a western-style economic system. Only this appealed to Western creditors who held most of the country’s foreign debt. This also explains why the reform could be quickly completed only in Poland, despite the IMF's hope to repeat that success in other countries in the region. Debt reduction symbolically closed the first stage of economic transformation, but it also had a very pragmatic effect in consolidating the

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[595] The reform in Russia was modelled on the Polish reform; in: Sachs J., *What I did in Russia*, March 14, 2012.
[596] Aslund A., *How Capitalism was Build: The Transformation...*, p. 293.
[597] This is how Sachs recalled the IMF's role in Russia after 1991:”The IMF’s point man, Mr. John Odling Smee, who lasted for a decade as the head of the IMF’s efforts, was busy telling the G-7 that Russia needed no aid, that the “balance of payments gap” as calculated by the IMF was essentially zero. [...], in: *What I did in Russia*. J. Odling Smee, in his memoirs pointed to Western governments as a major culprit of not providing timely financial support for Russia's reforms; in: Odling-Smee J., *The IMF and Russia in the 1990s* , p. 13.

success of the reform in subsequent years. Janusz Sawicki, the chief negotiator of the Polish debt until 1991, believed that debt reduction was central to Poland's financial integration within the international community. He also remarked that if Poland were not granted debt reduction this would be tantamount to an imposition of a hidden tax on society in the most difficult period of transformation.[598]

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In 1993, one of the Executive Directors, Michel Sirat, emphasized that prospects for sustainable growth in Poland would be increased if the country could benefit from higher levels of foreign direct investment and access to capital markets. These, in turn, required fostering of structural reforms, notably privatization, and a rapid conclusion of the ongoing discussions between Poland and its commercial creditors.[599] On the one hand, privatization, as a process of ownership transformation, was crucial for the prospects of a long-term economic growth. On the other, debt reduction would contribute importantly to the strengthening of Poland's balance-of-payments over the medium term. Both processes, however, were expected to enhance Poland's access to international capital markets.[600] One could ask, which of the two was more vital to the success of the Polish transformation in the long run? Sirat pointed to the latter as a prerequisite considered by the markets for any return to external credibility. Below I will argue for this thesis.

It should be emphasized that debt reduction was that aspect of the reform, which, more than privatization, unified successive governments around the strategic goal of the transformation process. Consensus over this issue ensured continuity in economic policy between 1989 and 1994. This was particularly striking during the periods of Jan Olszewski's and the post-communist governments, since it was at that time when the continuation of the rapid transition was officially challenged by the authorities. Only the prospect of finalizing debt reduction operations could prompt both governments to return to the path of the reform launched in 1989. According to Mark Allen, the post-communist government was even more zealous than the previous ones in continuing the current course of the reform, since, due to its past, it was eager to prove its credibility to the West. At the end of 1993, Allen claimed that the new leftist government greatly desired an agreement with the Fund for 1994, „partly for debt

[598] Author's conversation with Janusz Sawicki.
[599] IMF Archives, *Poland-First Review of the SBA 1993*....
[600] IMF Archives, Poland 1994, *Letter of the Managing Director to Henryk Chmielak* (Acting Minister of Finance), April 1, 1994.

reduction, and partly for general respectability and attracting foreign capital".[601] During the transformation, the issues of debt reduction and external viability went beyond political boundaries.

Against this background, it is easier to understand how politicized the privatization issue was. Stefan Kawalec, who was a Deputy Finance Minister in all five governments in the period between 1989-1994, said in an interview with the author that none of these governments was against receiving debt reduction. This is an obvious statement, but juxtaposed with the sensitive issue of privatization, it sheds a light on what actually propelled the transformation process. In 1993, the head of the post-communist government, Waldemar Pawlak, stated in his conversation with Allen that privatization was „surrounded by an extraordinary amount of emotions".[602] In March 1993, the Deputy Minister at CUP[603] complained to the latter that the mass privatization program was delayed as the Poles continuously debated the perfect solution, and it did not improve matters that each politician (including the president himself) had their own opinion on the issue. She also stressed an increasing xenophobia directed at the foreign advisors involved in the process[604]. Prime Minister Pawlak, as the leader of the Peasant Party, paid attention to the latter aspect saying in September 1994 that his main concern was the dominance of foreign managers in most firms selected for privatization.[605]

Privatization was delayed for yet another reason. There were no foreign investors willing to buy shares in Polish companies, even though capital privatization had been one of the main variants of ownership transformation considered by the Polish authorities for years. Here, the privatization problem was closely related to the debt reduction issue. Investors were discouraged by the vision of a government imposing taxes on privatized enterprises to obtain funds to service foreign debt. Thus, privatization, though necessary, was an insufficient condition for the inflow of Western capital. On the other hand, since debt reduction could meet the same goal, i.e. the inflow of foreign direct investments and private capital, and the process had already progressed to an advanced stage, it was more attainable than privatization.

[601] IMF Archives, Poland 1993, *Poland - Back-to-Office Report on the Political Situation*, M.Allen to M. Deppler, October 21, 1993.
[602] IMF Archives, Poland 1994. *Visit of M. Russo-Summary of Meetings*, September 29, 1994.
[603] CUP – Central Planning Office, an important institution preparing economic forecasts.
[604] IMF Archives, Poland, Correspondence and Memos, January-March 1992, *Discussion of Structural Policies with Mrs. Wasilewska-Trenker*, March 26, 1992.
[605] IMF Archives, Poland 1994, *Poland-Update*, M. Rodlauer to M. Deppler , September 12, 1994.

Political stabilization was another key condition for the inflow of foreign capital to Poland. In 1992, Zbigniew Brzezinski, former National Security Adviser to American President Jimmy Carter, drew attention to the responsibility borne by the West for the developments in Eastern Europe. Addressing the political paralysis that impeded foreign investments in Poland, he emphasized that „the West does have a stake here, and that the collapse of communism must not be quickly followed by a failure of democracy. It is vital that a successful model be developed in Poland, Czechoslovakia and Hungary”.[606] Thus, debt reduction appeared to be a more effective and realistic instrument than privatization or political stabilization for pursuing Poland's interests (in restoring confidence in external markets) and securing the interests of the West (better chances for consolidation of democracy in Poland and, thereby, in the region).

On the one hand, continuous strikes in 1992-1993 leading to the shocking victory of the post-communists in 1993 and, on the other, lack of consensus over the correct privatization path, inevitably elevated 'apolitical' issue of debt reduction to a priority on the agenda of successive governments. This statement is of significance in the context of the internal debate (described in the early part of my thesis) on the pace and sequence of the reform that took place in the Fund in September 1989. Thomas Wolf argued for starting the transformation process not from macroecconomic stabilization, but from institutional changes, including privatization, and, at the same time, he emphasized the desire for quick and radical action declared by the new government of Tadeusz Mazowiecki.

It turned out, however, that the privatization issue was very controversial and sensitive, and, consequently, work toward that goal was significantly delayed. On the other hand, it can be assumed that had priority been given to the rapid introduction of tight financial policies, i.e. shock therapy, it would also have quickly fallen from government's agenda. In order to consolidate the rapid transition reform as a strategic goal, a political consensus over debt reduction was needed. The reduction, however, would not have been possible in the variant of a gradual approach, which assumed slow institutional changes, but only within a rapid approach, more specifically - the rapid transition to a free market system modeled on Western countries. Notably, the debt reduction process was structured into three phases and these were triggered depending on the progress of implementation of stabilization-cum-systemic reform. This factor turned out to be what ultimately defined the pace and sequence of reform in 1989-1994.

[606] The MacNeil/Lehrer Newshour, June 2, 1992.

Appendix 1. Egypt

In 1990-1991, Egypt was the only country next to Poland with a chance for a significant reduction in foreign debt. The comparative analysis[607] of the most indebted countries made in the Fund just before the granting of the first tranche to Poland singled out the two countries in this respect pointing to their heavy indebtedness to official bilateral creditors.[608] In 1990, foreign debts of Poland and Egypt were of similar magnitude - 48 and 50 billion dollars, of which two-thirds were owed to the Paris Club in both cases.[609] However, the more important argument for debt reduction was the political one. In this context, it is worth to recall the analysis of November 1989 written by the IMF expert, who sought for the possibilities of ensuring additional guarantees for the Fund resources invested in the risky economic reform in Poland. Searching for a precedent, he mentioned Egypt: in 1987, the IMF did not obtain the consent of the Paris Club countries to reduce Egypt's foreign debt because, according to the IMF, the Club did not have "political will" to so.[610] For this reason, no special guarantees were granted to the Fund.

In the spring of 1991, Western creditors demonstrated the political will to grant significant debt reduction both to Poland (in April) and Egypt (in May). It should be emphasized that it was political (not economic) considerations that helped the West restrict debt reduction to only these two countries. In the first case, the West wanted to demonstrate how important it was for such a large European country to move to Western capitalist democracy. This was strengthened by the determination of the Polish authorities to implement the *unique* transition reform. Egypt, in turn, received the reduction - including the entire 7 billion dollar military debt to the US - mainly for supporting the United States in the Gulf War. According to the US Administration in 1990, it was the context of the military debt that explained the *uniqueness* of the Egyptian case and, consequently, was to prevent it from becoming a precedent for others to gain comparable debt relief.[611]

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[607] IMF Archives, Poland, Correspondence and Memos, March-April 1991, File 1. *Debt Reduction by Official Bilateral Creditors: Country Cases Poland and Egypt vs. Brazil, Hungary, and the Philippines*. March 4, 1991.
[608] IMF Archives, Poland, Correspondence and Memos, March-April 1991, File 1. *Debt Reduction by Official Bilateral Creditors: Country Cases Poland and Egypt vs. Brazil, Hungary, and the Philippines*. March 4, 1991.
[609] Nowels L., *Egyptian Military Debt Forgiveness: Costs, Implications, and the Role of Congress*; p.2.
[610] IMF Archives, EURAI, Country Files, Poland, Box 63, *Guarantees to Fund Operations*, J. Pujol to L.A. Whittome, November 27, 1989.
[611] *Egyptian Military Debt Forgiveness...*; p. 11.

Economic criteria played an important role only insofar as they provided a formal justification for debt reduction. Foreign debt was treated by creditor governments as a tool for achieving political interests, while such factors as size of debt, general condition of economy or even economic policy had a secondary meaning to them. Suffice it to compare the two main macroeconomic indicators of Poland and Egypt in the second half of 1991: inflation and budget deficit. While they were at alarming levels in both countries, Egypt's deficit was particularly sizeable – it was as high as 20 percent of GDP in 1991.[612] However, it was Egypt that was still attracting external financing from the West, and not Poland. In October 1991, the World Bank’s lead economist for Poland, Luca Barbone, wrote to Ian Hume, the Resident Representative of the World Bank in Warsaw: „pursuant to the Camp David agreements, Egypt is now the happy recipient of an extremely large amount of direct foreign aid from a large international donor. This allows the Egyptians to finance a much larger deficit than it would be possible to the Poles.”[613] At the time, though, it was the Polish government that faced a non-financable deficit if it wanted to preserve the achievements of the radical and unprecedented economic reform, i.e. proper levels of net international reserves and inflation.

Importantly, Egypt did not fight inflation as efficiently and consistently as Poland. In this context, both Leszek Balcerowicz and Luca Barbone challenged the official Egyptian inflation of 25 percent by pointing out that the Egyptians relied on price controls and other market distortions.[614] Furthermore, according to the IMF, Egypt was most heavily dependent among debtor countries on financial flows (grants, private transfers, etc.) to service part of its debt. Taken together, this did not support the case for the need of continued financial assistance from the West. Hence, Egypt’s international significance stemmed from its status of a badly needed military ally of the US. At the very same time, Poland could not count on such a scale of external financing since the country diverged from the path of the rapid transition reform which was its sole international asset.

The third similarity between the two countries, along with their heavy indebtedness to the Paris Club and the political nature of debt reduction, was that they embodied a piecemeal approach to the management of the international debt crisis. As a matter of fact, the two country cases sparked divisions among the creditors in their disputes on the proper international debt strategy. Both on the forum of the Paris Club and the G7 countries,

[612] *Financial Times*, October 18, 1991.
[613] IMF Archives, Correspondence and Memos, October-December 1991, File 4, *Meeting with Balcerowicz*, L. Barbone to I. Hume, October 25, 1991.
[614] Ibid.

concerns were raised that creditors could not offer the option of such a large debt reduction to only those two countries, but that it should be extended to include other middle-income debtor countries as well.[615]

It needs to be stressed that within the Paris Club countries it was the United States that lobbied hardest for the large scale debt reduction for both countries. While other creditors objected to the policy of trying to limit the application of the policy precedent set by the Polish and Egyptian debt deals[616], the US Administration feared that many countries would demand the same concessions from America.[617] These fears were not unfounded: in 1990, Israel turned to the US with an official request for debt reduction, and in September alone, the United States received pledges of about 20 billion dollars from allies and Gulf states for financial assistance due to the crisis resulting from the Gulf War.[618] Besides, the United States were the major holder of Latin American countries' debt. As a result, the Polish and Egyptian debt reductions were both unprecedented and unrepeated, and this made them all the more special since they took place somewhat on the sidelines of the mainstream solutions to the global debt crisis devised at the end of the 1980s and implemented in the early 1990's.

[615] *Financial Times*, April 30, 1991.
[616] Ibid.
[617] *Egyptian Military Debt Forgiveness...*; p.1.
[618] Ibid, p. 10.

Appendix 2. Hungary

In 1989, Hungary was the most indebted country in Comecon[619], next to Poland.[620] In the new geopolitical reality, an important determinant of economic policy in both countries was the prospect of receiving Western financial support: in Poland in the form of reduction in foreign debt, in Hungary in the form of permanent access to international credit markets. Over time, the desire to receive full debt reduction turned out to be the most effective stimulus for Poland to complete the rapid transition reform and cooperation with the IMF. In Hungary, the need to preserve solvency defined economic priorities such as export orientation, shape and pace of privatization[621], attracting FDI and maintaing good relations with foreign banks.

Inability to service huge foreign debt even in the long term was recognized by the Polish government yet before the reform started[622] and, as a consequence, the liquidation of this burden became a strategic goal for successive governments. In Hungary, where per capita debt was the highest in the world [623], the government was willing[624] and able to manage the debt without any form of restructuring. Indeed, the case of Hungary illustrated the unique case of a highly indebted country, which was expected to continue its debt service and to do so while growing out of their debt problem.

[619] Council for Mutual Economic Assistance (Comecon or CMEA) was the response of the USSR to the formation of the OECD. The aim of this organization was to expand economic integration among communist countries.

[620] Following an effective external adjustment in Hungary in the first half of the decade, the communist authorities decided to ease financial policy, as a result of which Hungary's foreign debt increased by almost half: from 14 billion dollars in 1985 to 20.6 billion dollars in 1989; in: Kiss J., *Debt management In Eastern Europe*, p. 55.

[621] „In January 1990, the first postcommunist government of József Antall announced that 85% of privatization revenues would be channeled toward the repayment of state debt [...] Foreign debt management appear among the important roots of Hungary's strong export orientation and privatization strategy of massive sale of state property to foreigners", in: Hanley E., King L., István Tóth J., *The State, International Agencies, and Property Transformation in Postcommunist Hungary*, p. 146.

[622] As Poland virtually did not service its debt to government creditors throughout the 1980s, the interest accrued in this way were added to the debt stock, and under the circumstances of the economic collapse, became unpayable.

[623] *The State, International Agencies, and...*, p. 145. Hungary's per capita debt amounted to 1,561 dollars. The second most indebted country in the world was Brazil, with a per capita debt of 622 dollars; in: Linz, S., *Problems of democratic transition and consolidation*, p.300.

[624] „In the spring of 1990, shortly before the inauguration of the first democratically elected postcommunist government of József Antall, there was a meeting of would-be top policymakers [...] Like the earlier team, the participants of this meeting did not find any alternative to disciplined and regular debt service" [emphasis added to indicate continuance of the debt management policy before and after 1989], in: Greskovits B., *The Political Economy of Protest and Patience: East European and Latin American Transformations Compared*, p. 63.

After 1989, a factor that significantly influenced the choice of foreign debt management was that both countries were geopolitically 'unimportant' to the West, the United States in particular. This factor – as I tried to prove in the second chapter – contributed largely to the choice of the radical reform in Poland, which immediately turned to a major Polish asset in bargaining with the West. In Hungary, due to a relatively stable economy and much deeper integration with the West through debt, trade and capital[625], such a radical reform would significantly lower the chances of maintaining access to foreign credit markets. Hence, Hungarians recognized their biggest asset in continuing impeccable debt service and their high reputation in the West for financial management expertise. In short, Hungary and Poland made the choices to build their international bargaining power on, respectively, the continuity of the gradual approach and the implementation of the shock therapy.

It is worth to emphasize the above distinction: Western creditors and Western governments. The Poles considered the creditors and governments as the representatives of the same group with which the new democratic government was conducting debt negotiations. This distinction was more relevant in the case of Hungary, where most of the debt was owed to financial institutions and debt to bilateral official creditors was small. Such a debt structure was of great significance to the adopted approach to the debt management and economic policies in both countries. One should keep in mind that at the end of the 1980s, i.e. in the final phase of searching for a solution to the global debt crisis, the position of private banks as creditors deteriorated in the face of an 'alliance' of international financial institutions and official creditors. Poland, being encouraged by influential figures from international financial circles and, indirectly, by the IMF, decided to 'play tough'[626] and not to pay interest to the banks. Hungary, by contrast, relied on good relations with western bankers, for whom the issue of maintaining debt service was an indisputable proof of a debtor's solvency. By rejecting the debt relief option, the Hungarians linked their debt strategy to the expectations of Western commercial banks. At the same time, Poland coordinated its overall debt management policy with the IMF and Western governments, which was not without profound financial consequences for the country as these institutions, and not banks, were responsible for creating a new international financial architecture that put an end to the debt crisis.

[625]Greskovits B., Bohle D., *Development Paths on Europe's Periphery: Hungary's and Poland's Return to Europe Compared*; p. 20.
[626] Gomułka S. to Balcerowicz L., *On the Balance of Payments, Financing Gap, the IMF and the issue of debt reduction*, January 25, 1991; Polish Transformation..., 1991-1993, p. 852.

Therefore, although both countries shared the same strategic goal - to manifest their creditworthiness and thus regain the confidence of foreign investors and international creditors - they followed fundamentally different paths to attain it. This had profound consequences for macroeconomic policy. Poland, due to the huge financing gap and the lack of payment capacity, resorted to debt suspension and foreign credit restraint as part of the shock therapy (which itself was supposed to be a demonstration of creditworthiness). Hungary, on the contrary, was determined to continue reliable and timely debt service with a view to maintain open access to foreign capital markets. This, in turn, was needed to preserve the very same longstanding positive debt service record as well as to finance social spending.[627] Hence, the persistent refusal to enter debt restructuring process - the choice often misunderstood abroad.[628] External markets could react negatively if the government made radical changes to the current policy since it would jeopardize many of Hungary's achievements such as relatively high living standards, international banking credibility and partly functioning market institutions.[629] Therefore, the government decided to stay the course of ‘continuity’ and conduct gradual reforms.

What were the results of these two different debt strategies? It seems that in the short term Hungary's strategy brought the country more good than advantages that the shock therapy offered to Poland. The crucial importance given to the sustainable payment capacity worked for Hungary's creditworthiness. When in 1991 Poland struggled with a double crisis in real economy and public finance and was cut off from external sources of financial assistance, Hungarian government managed to attract about 3 billion dollars in foreign direct investments and mid-term credits. Besides, official reserves were rebuilt from negligible amounts to a level of half year of imports.[630] The latter achievement was an illustration of a much better export performance than in Poland, where the government, under strong social pressure, was wasting foreign exchange reserves on importing (mostly) consumer goods.

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[627] On financing social expenditures with foreign credits before and after 1989 see: Kornai, J. *Paying the Bill for Goulash Communism: Hungarian Development and Macro Stabilization in a Political-Economy Perspective*.

[628] This is how Massimo Russo described the Hungarian government attitude to Western financial assistance before the conclusion of economic program with the IMF: „We have difficulties with the Hungarians' attitude that their situation is very different from Poland's, that they do not need aid and that all they are asking is facilitate their access to financial markets and export markets”, in: IMF Archives, EURAI, Country Files, Poland, Box 63, November 1989, *Brief for President Delors' Visit to Hungary and Poland*, M. Russo to the MD, November 14, 1989.

[629] Hare P., Révész T., Aven P., Oblath G., Sinn H., *Hungary's Transition to the Market: The Case against a 'Big-Bang'*; p. 230-231.

[630] Hajna Istvanffy L., *Foreign Debt, Debt Management Policy and Implications for Hungary's Development*, p. 1001.

However, the Polish path of transformation turned out to be more beneficial in the long run. Already in 1993, economic growth in Poland continued for the second year in a row, inflation was falling, the budget deficit was smaller than forecast, and foreign debt was reduced by 30 percent. In Hungary, at the time, inflation was on the rise, government's debt reached 90 percent of GDP[631], and current account deficit amounted to 9 percent of GDP in 1994, which clearly showed limits of the economic strategy prioritizing continuous debt service. As a result, in March 1995, the debt situation and a worsening credit standing forced the socialist government to make a radical turnaround in economic policy by introducing the so-called Bokros Package.[632]

Until then, financial efficiency of the Hungarian economy had been subordinated to the priority of maintaining living standards at the expense of increasing foreign debt. In 1995, restoring macroeconomic balance became an imperative which required tight financial policies with detrimental effects on living standards. It is worth to mention that for Hungarians, unlike for Poles, the economic transformation after 1989 did not mean a radical though *desirable* economic reform but a gradual though *irreversible* departure from the good times of "the goulash communism". Janos Kornai, the most famous hungarian economist, dated this 'consumer lending' priority in contemporary Hungarian politics back to the 1956 Hungarian Uprising, as a result of which the authorities in order to appease the population had committed themselves to provide Hungarians with an ever-increasing standard of living provided they did not challenge the political legitimacy of the communist regime. In light of this, one could say, breaking the 'sacrosanct' agreement by any government (either communist or democratic) required more political courage than starting shock therapy in Poland. The Polish economy had been in a deep economic crisis since the late 1970s and a desire to recover from the crisis was greater than facing the prospect of belt-tightening.

The relationship between living standards and foreign debt problem is well illustrated by the different rationales behind the debt accumulation in both countries. To put it briefly, in Hungary foreign debt was always considered the most vital issue to the country's economic performance, while in Poland debt was more a political issue. While in Hungary foreign debt was of existential importance, in Poland it was of a more esoteric nature. In case of Hungary, it would be easy to point to the ultimate benefits of the huge debts incurred in the decades preceding the trasformation – these were the relatively high living standards on a permanent

[631] *The Guardian***,** October 29, 2008.
[632] „What made the March 12 stabilization so urgent was the threat of great dangers to Hungary on the international financial market", in: Kornai, J. *Paying the Bill for Goulash Communism...;* p.1022.

basis and the stable economy, whereas in Poland indebtedness turned to a great and ever-increasing burden on the economy, with no lasting positive effect, especially in consumption. In Hungary, foreign debt accumulation and the implementation of a remarkable economic reform of 1968 proceeded more or less in parallel, while in Poland debt was a substitute for economic reform. For Hungary, as a country with very limited natural resources and a very export-reliant economy, access to foreign loans was considered the key to secure the 'social agreement, while in Poland, since 1992, the prospect of finalizing debt reduction was inextricably linked with tightening fiscal adjustment, and thus with lowering living standards.

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