

FUTURE FUELLED
BY KNOWLEDGE



ORLEN

VOLUME 1

JANUARY 2011

THE STATE AND THE MARKET

In Search of a New Balance



ORLEN
CONFERENCES

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COVER DESIGN

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DTP

A VISTA GROUP SP. Z O.O.
UL. H. DEMBIŃSKIEGO 10
01-644 WARSZAWA
www.avistagroup.pl

PROOFREADING

TERESA PAPLIŃSKA

PRINT

DRUKARNIA OFFSET-PRINT
UL. MICKIEWICZA 18
05-816 MICHAŁOWICE

PUBLISHER

PKN ORLEN SA
UL. CHEMIKÓW 7
09-411 PŁOCK
www.orlen.pl

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INTRODUCTION

Ladies and Gentlemen,

You are holding the first issue of PKN ORLEN's new quarterly "State vs. Market. In Search of a New Balance", the first in a series of publications intended to explore the strategic issues related to economy and the energy sector. The publications will accompany PKN ORLEN's annual conferences organised under the umbrella title: "Future Fuelled by Knowledge".

These conferences and publications were inspired by the 20th anniversary of Poland's embarking upon the privatisation process. Public-to-private ownership transformations were at the heart of the process aimed at recreating a market-based system after half a century of command economy and the rule of bureaucracy. They were of vital importance, and without them, the proper allocation of capital and production capacities would not have been possible. However, the thematic scope of our quarterly will go far beyond the issue of privatisation. Since 1990, a host of new institutions stabilising and regulating the Polish market have been established. The quality of relations between the state and the market has noticeably improved. Large and rapidly-growing companies have sprung up, capable of successfully operating on international markets and competing with other European players.

However, we want this publication to serve primarily as an occasion to initiate a wider discussion on the contemporary world's key economic, business and social

challenges. The recent worldwide economic turbulence has changed the perspective on state-market relations, prompting many politicians to wonder how to redefine the state's role in the economy. Therefore our publication is well timed to open a debate on where the markets are evolving and how the extent of the state's institutional influence on economic decisions should be redefined in the post-crisis era. We intend for our publications and conferences to serve as a platform for sharing views, experiences and knowledge relating to the strategic challenges faced by Poland, Europe and the world.

The first issue of the quarterly entitled "State vs. Market: In Search of a New Balance" is devoted to one of the crucial ongoing economic debates. The articles published here probe for answers to questions that are particularly relevant for Poland given its experience of transformation and rebuilding of capitalism. These issues are deeply embedded in the global context, in a world suffering from crisis and experiencing failures of large market players. Only through an in-depth analysis of the processes that are ongoing will we be able to ensure success in the "future fuelled by knowledge".

I encourage you to read on,

Jacek Krawiec
President and Chief Executive Officer
PKN ORLEN

POLAND – THE PIONEER IN POSTCOMMUNIST REFORMS



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The year 1989 marked the liberal revolution of Eastern Europe. In that fall, the communist governments fell in one country after the other. Revolution spread like wildfire, reminiscent of the great liberal revolution of 1849. Timothy Garton Ash quipped: “In Poland it took ten years, in Hungary ten months, in East Germany ten weeks: Perhaps in Czechoslovakia it will take ten days!” (It actually took 24 days.) Poland took the lead, and twenty years after these events, it is worthwhile to remember and recognize Poland’s special role in post-communist transformation.

Among the postcommunist countries, Poland stands out as the possibly most successful political and economic reformer. It is a full-fledged democracy, a member of the European Union and NATO. It is no exaggeration to state that the last twenty years have been happiest in a millennium of Polish history. They have been characterized by peace, democracy, and rapidly rising welfare. Finally, Poland has returned to Europe and become a normal society. Although Poland competed with Hungary to be the pioneer, Poland stood out as the true leader in this development, and it has certainly been more fortuitous. Why has it been so lucky? The answers are many, because in the same way as failure is an orphan, while success has many parents.

The fundamental cause of Poland’s success lies paradoxically in its sad history. Norman Davis has named his monumental history of Poland, “God’s Playground,” and it really was. Poland suffered from its geography, located between Russia and Germany, which both eventually became stronger than Poland, but that was not true a few hundred years ago. Poland was too strong to succumb, but it was not forceful enough to win. Its flat and open fields made it an ideal battlefield, while it had too few hills and castles to be perceived as a natural obstacle. Its strong Catholicism between the orthodox east and the protestant north and west contributed to its alienation, as did its early and strong nationalism. Poland seemed created to stand out but to lose. For the postcommunist period, however, all this suffering meant that Poles had a strong national identity. They knew who they were, and they were proud of being Poles.

All this political turmoil left two contrarian economic legacies. One was a large number of free and noncommunist economic elements. The other was persistent economic underperformance and imbalances. Poland was ready for early democratization. Jaruzelski’s communist government could barely rule because of strong opposition from Solidarity and the Catholic Church. In early 1989, Poland’s tragic history started to turn around through a number of policy innovations. The first was roundtable negotiations between the government and Solidarity. The parties agreed to hold partially democratic parliamentary elections on June 4, 1989, which delivered the first democratic breakthrough in the communist world. This date marks the beginning of the end of communism. The elections were a landslide victory for Solidarity.

The summer of 1989 was characterized by negotiations and political uncertainty. Amazingly, the demoralized

communists gave up power voluntarily. In September 1989, the first predominantly anti-communist coalition government was formed under Prime Minister Tadeusz Mazowiecki.

The key person was the liberal Professor of Economics Leszek Balcerowicz became Minister of Finance and Poland's chief economic reformers. Balcerowicz had several properties that made him an outstanding reformer. He had a good understanding of the economic situation, thought strategically, honestly wanted to do the best for his country, and he was absolutely stubborn as long as he was convinced that he was right. Instead, it has stuck to elementary and lucid liberal principles. Together with a team of Polish and foreign advisors, including the Americans Jeffrey Sachs and David Lipton, they worked out a novel reform program.

Since Poland was the first postcommunist country, it had little choice but to deliver a series of policy innovations. The greatest innovation was the Balcerowicz plan. It was published on one newspaper page in the fall of 1989. It amounted to a radical, comprehensive reform, going further than the prevailing Washington Consensus. It focused entirely on Poland, but its prescriptions applied to other countries in similar predicaments. This program is easy to summarize:

1. Macroeconomic stabilization. The immediate concern was to halt hyperinflation, which required a swift reduction of a large budget deficit. Fiscal policy had to be centralized and brought under control by a reinforced Ministry of Finance. Monetary policies should be tightened, and positive real interest rates were necessary. The Central Bank had to be independent and focus on low inflation. The exchange rate had to be unified and the currency needed to be convertible on current account to be freely available for foreign trade.

2. Deregulation. Prices had to be deregulated and price subsidies eliminated to let demand and supply determine prices. Domestic trade should be liberalized and monopolies broken up to avoid monopolistic pricing. A regime of relatively free foreign trade had to be established, eliminating rents in both exports and imports. A realistic

price structure then would be imported. Free trade would alleviate the rampant shortages, facilitate production, and boost living standards.

3. Privatization. Restrictions on the private sector had to be abolished and new private entrepreneurs offered a maximum of freedom. Small-scale privatization was to be initiated early on. The privatization of large and medium-sized enterprises had to be started as soon as possible, but everybody understood that it would take time, and no agreement existed on how to do it.

4. Reinforcing the Social Safety Net. The ardors of restructuring required the introduction of a social safety net targeted at new groups in need, especially the unemployed, and an increase of pensions.

In principle, most qualified economists agreed on these four basic policies, while much discussion was devoted to their exact content.

The radical Polish liberalization consisted of four vital measures: first, a far-reaching price liberalization; second, a truly radical external liberalization; third, the breaking up of state concerns and associations into single enterprises; fourth, and possibly most importantly, a legal act allowing anybody to sell anything any time in any place at any price to anybody. As a result, central squares in big cities were flooded with people who just started trading and soon made a living, absorbing substantial employment. Within two years, the most successful street traders had established themselves as real merchants and shopkeepers, and ever since Poland has stood out as the country with the most competitive domestic market.

Balcerowicz was focused on long-term goals and he did not fall into the trap of trying to justify its policies with cost-benefit analysis, which is inevitably both flawed and short term. He disregarded those who quarreled that the government policy represented “overshooting.”

The Polish government talked about radical, comprehensive economic reform or a big bang, but the popular nickname became “shock therapy.” The crucial insight was that both speed and comprehensiveness of reform

was vital. Everybody realized that privatization of large enterprises would take years, as would complex reforms, ranging from tax reform, social reforms, civil service reform, and legal reforms to the development of a financial sector, but a radical and comprehensive reform was needed to bring about a real breakthrough, which would minimize the social costs and render the economic upswing earlier and sharper. The arguments were many.

Liberal economists had bitter memories of Poland's many failed and reversed reforms. Balcerowicz concluded "that the economic reforms failed because they were not radical enough, that is, they did not reach a certain threshold of necessary changes rapidly" via "critical mass" of market reforms. If the system did not achieve a certain degree of cohesion and consistency, it could theoretically be even more inefficient than the old command economy.

Radical reformers were acutely aware of the prevalence of both state and market failure, but they were more fearful of state failure. A new market would be imperfect, but the communist state was even more imperfect, so it could not be entrusted with much intervention. The reforms had to deliver a "shock" that could break the hold of the old system to introduce a viable new market economy.

People's expectations had to be changed to render the systemic changes credible and irreversible. Balcerowicz derived from Leon Festinger's theory of cognitive dissonance in social psychology "that people are more likely to change their attitudes and their behaviour if they are faced with radical changes in their environment, which they consider irreversible, than if those changes are only gradual." Otherwise, people would suspect a rollback toward communism and refuse to adjust.

Because of the severity of the crisis and the new hope of freedom the public was prepared to make short-term sacrifices for long-term benefits of society out of sheer idealism. Balcerowicz emphasized the importance of utilizing this period of "extraordinary politics" to get a full package of reform laws adopted by the Parliament, while radical economic reforms remained popular. Quick systemic change also transforms the intellectual paradigm. The comprehensive reforms soon changed

the intellectual paradigm so that soon few remembered the regressive arguments presented by opponents to radical reform in 1989. Standard theories agreed that macroeconomic stabilization had to be done fast to break inflationary expectations.

Liberalization of prices and trade had to go far enough to generate a critical mass of markets and provide credible incentives. Since the old prices were hopelessly distorted, any gradual adjustment would send inaccurate signals about costs, demand, and supply. Inflationary expectations would be maintained, and entrepreneurs would be unwilling to invest. The profitability of an enterprise would be determined by price regulation, which would render bankruptcies socially unacceptable. Liberalized imports were vital to activate the market and end shortages.

The hardest task was to convince enterprise managers to alter their behavior. Their incentives had to be changed through the introduction of hard budget constraints or a "demand barrier." If they were not convinced that the rules had changed for good they would not adjust. Corruption, misappropriation of public funds, and rent seeking were rampant amidst the breakdown of communism. Partial liberalization facilitated arbitrage between regulated prices and free prices, but a quick and comprehensive reform could mitigate these distortions.

Extremely little accurate information was available during the early transition, as everything was changing fast and radically, and new statistics were often completely flawed. If little could be measured and few relevant facts could be established, it would have been both pretentious and foolish to attempt anything but a policy based on principle.

Finally, the state bureaucracy had numerous reasons to oppose a radical reform program. Under reform, it would lose its prior power, and most of its human capital would become obsolete as the old socialist micromanagement of enterprises no longer existed. Bureaucrats easily colluded with abundant secret service officers, state enterprise managers, and Communist Party officials. It was vital for the sustenance of democracy to disarm the old elite through radical reform.

Today, many of these insights appear prosaic and self-evident, but that became the case only after the radical reform had been implemented. At present, Poles tend to take the success of their reforms as a given, but anybody who believes that should look back at the literature of the time. For example, Edward Gierek's old chief economist Pawel Bozyk published a book in 1992 with the suggestive title: "Who is Guilty," which referred to Mazowiecki, Balcerowicz and their reform government.

The transition was full of uncertainty because this was uncharted territory, but new information was patently poor. Therefore, politicians had to stick to principles or ideology and disregard the initial, often distorted, facts. All politicians were nervous before the great price liberalizations and feared popular riots or strikes, as had been the habit under communism. In Poland, price liberalization led to a sudden price hike of 70 percent, far more than anybody had anticipated, but the government did the right thing: It stayed the course.

In 1992, its third year of economic transition, Poland returned to economic growth, before any other postcommunist country, and soon it reached a sound growth rate of 6 percent. Overall, it looks like the best performing postcommunist economy, and its successful reforms prove many things.

First of all, as John Maynard Keynes pointed out, nothing is stronger than ideas, and the Polish nation has blown new life into elementary liberal principles in Europe. The Balcerowicz program was the new paradigm that spread from country.

Second, these reforms show that there never was any benefit in going slow on any reforms. All reforms should be undertaken as fast as possible to reach the goal, because only with a certain consistency or critical mass of reforms can the economy or democracy be expected to function well.

Third, Poland has also shown that there is no contradiction between market reform, privatization, and democratization. On the contrary, they are complementary, and the more reforms that are undertaken early on the better for the population as a whole.

Yet as the pioneer, Poland could not avoid making mistakes or had to accept less than optimal decisions. In the economic reforms, two problems stand out. One is the early law on privatization, which effectively granted six different constituencies the right of veto against privatization. Little wonder that privatization proceeded more slowly than in other Central European countries. Even today, Poland has more state enterprises than its peers for no good reasons.

Another problem is that the first reform government was too afraid of social dissatisfaction. Their worst decision was to double the total cost of Polish pensions to 16 percent of GDP, which was actually the highest in the world, about twice as high as in Western Europe. The pensioners were not happy but voted to a disproportionate extent for the communists in any case, and it has been extremely difficult for subsequent Polish governments to scale back excessive social transfers.

Poland's accession to the European Union has not been helpful in this regard, and in the first years of the new millennium, just before Poland's accretion to the EU in 2004, it appeared as if Poland had got stuck in a social welfare trap with large social transfers, high taxes, but even so a significant structural budget deficit and low economic growth. Fortunately, this problem has been addressed, and Poland's economy has flourished again.

The test of Poland's economic transformation has been the global financial crisis of 2008/9, and Poland stands out as a true success, being the only EU country growing in 2009. The reasons for its progress are multiple. Thanks to a floating exchange rate, its capital inflows were comparatively limited. The National Bank of Poland (NBP) was adamant about inflation targeting and maintained a very low inflation by keeping positive real interest rates when virtually all other countries failed to do so. The NBP leaned against the wind, when it perceived that asset prices, notably housing prices, were rising too steeply. Unlike other East European countries, Poland introduced special regulations to limit the volume of mortgages in foreign currency, which slowed their growth. As perhaps the only country in the region, Poland has not faced any real banking crisis in the last

two decades. With its stellar monetary policy for many years, Poland could get away with a comparatively large budget deficit.

Many factors and persons have contributed to Poland's stellar postcommunist success, and Poland has led the

way in so many ways. Today, it appears the most successful of all the postcommunist economies when not only dynamism but also solidity of its fortunes is considered.

A FINANCIAL CRISIS OR A CRISIS OF THOUGHT?



**PROF. LESZEK
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While the term “economic crisis” is commonly associated with the market and capitalism, the most severe crises and economic breakdowns occur in those systems where there are no limits or only weak limits to political power (the state) and therefore the private and legal sector, and the free market, are non-existent or largely non-existent.

An extreme case of such a system is **communism**. The political power in a communist country is subject to no institutional constraints, there is no division of powers, and what is more, because of state ownership monopoly, the political power is mixed with economic power. When such extensive power was placed in the hands of corrupt, or reckless and incompetent individuals, decisions were made that led to critical economic disarrays, which became very painful to the people. In the most dramatic cases they took the form of humanitarian and economic disasters (like the Stalinist collectivisation of agriculture in the USSR in 1930, the Great Leap Forward and the Cultural Revolution in Maoist China, or the crimes of the Red Khmers in Cambodia). Less drastic but nevertheless economically destructive cases involved “political and economic adventurism”, such as forcing through the cultivation of corn in the USSR by Khrushchev or of sugarcane in Cuba by Fidel Castro, or leading Poland into the trap of foreign debt under Gierek’s rule, Romania under Ceausescu’s rule, or Hungary under Kadar’s rule.

Many states have **quasi-communist** systems (large state sector and small private sector). Those include Iran and other oil countries as well as, until recently, numerous countries in Latin America. Venezuela under Chavez is moving in the same direction. Again, the extensive political and economic power in such regimes frequently results in an economic policy that brings about a deep economic slump.

Among the countries which are considered capitalist there are also examples of states in which the private sector is prevailing, but it is made up of a privileged minority and a discriminated majority (Indonesia under Suharto being a case in point). The minority are connected to the ruling politicians by family and other ties, and thus benefit from better state and legal protection, licences, etc. Such systems are often nicknamed crony capitalism. The very existence of such connections makes the privileged minority benefit from convenient terms of financing provided by the financial markets. This is because the financial markets assume that the ultimate guarantor of credit is the state (which reduces the risk premium). This leads to excessive private debt and in turn a crisis. The same mechanism operated in the case of American financial institutions which, while formally private, were in fact highly politicised: Fannie Mae and Freddie Mac (see below). This also may occur in the case of state-owned companies.

In all of the systems mentioned above, the extensive and unlimited, or only weakly limited political power fosters the risk of serious economic breakdowns, albeit to a varying extent. But it also eliminates or undermines systematic development drivers of fundamental importance, in particular market competition and, as a consequence, the most crucial of the development forces – innovation in the economy.

Also, in **Western-type capitalism** (represented by the OECD countries), serious crises and economic break-

downs are not created by the free market but are politically induced. What I mean here is two categories of crises: fiscal crises and crises in communist enclaves.

Fiscal crises are typically caused by prolonged periods of growth of state budget expenditure, most often social expenditure, leading to the accumulation of public debt, which at some point exceeds, often abruptly, certain security limits. Hungary and Greece are only two of the numerous representatives of this category of states. A rapid expansion of public debt is also a side-effect of a financial crisis (see below) and a crisis-response policy designed to alleviate recession (this has been particularly visible in the U.S. recently). However, a fiscal crisis is not the only threat posed by an increasing proportion of budget expenditure to the GDP. An additional factor that comes into play, especially when social expenditure is on the rise, is a systematic impediment to growth. Such expenditure frequently reduces the supply of labour and (along with budget deficit) takes a toll on the country's savings, which in turn dampens investments and fuels demand for foreign capital. The latter, especially if it takes the form of loans and is dispensed in relatively large doses, sometimes becomes yet another source of economic instability (capital inflows and outflows). Furthermore, large and growing budget expenditure requires correspondingly high taxes, which, to a varying extent (depending on the type of tax), hampers economic growth. The fact that growth is systematically impeded by the heavy burden placed on the economy by expenditure, public debt and taxes are underestimated in Poland, despite the vast amount of literature on the subject. Meanwhile, this is probably the major reason why our economy cannot turn into an economic tiger.

Crises in communist enclaves occur in those parts of the economy which are formally (state ownership) or informally connected to the political power. Some of the long list of examples, which we have seen recently, are regional banks (Länderbanken) in Germany, cajas in Spain (whose ownership structure is similar to that of regional banks – the dominant owners in cajas are the regional authorities), Fannie Mae and Freddie Mac. Of course, everyone can see that private banks do fall into crises as well. However, not everyone will notice that

this predicament clearly tends to occur more often in the case of politicised banks (see the work of the World Bank). What is more, the financial crises affecting private banks (in the majority of the OECD countries there are no state-owned banks) can be tracked down to misguided interventions of public authorities.

Crises in communist enclaves are often – in popular opinion – blamed on capitalism, while in fact, as in the cases discussed above, they follow from the actions (and omissions) of public authorities, which are the final decision makers and/or protectors of certain companies.

Probably the greatest amount of misconception exists with respect to **financial crises in capitalism**, namely crises that emerge in the financial sector and then, through specific mechanisms, spill into other areas of the country's economy. If the country is material to the global economy (like the U.S.), such a crisis affects, although to a varying degree, also the rest of the world. The situation that follows is a global financial and economic crisis. To date it has occurred only twice: in the 1930s and in the years 2008–2009. But it must be noted that the gravest cases in the 1930s were much more serious than the most difficult cases in 2008–2009.

The recent global crisis, just like the previous one, triggered a wave of rather superficial interpretations, including the following opinions:

- It is a crisis of capitalism – this statement, however, makes no differentiation between a crisis “in capitalism” and a “crisis of capitalism” (that is a crisis of the private ownership and the market), and the roots of the crisis are definitively attributed to the private sector, without adequate evidence to support such a thesis.
- It is a crisis of “neoliberalism” – the word is used as a kind of abuse, just like “bourgeois” in the communist times. But abuse is no substitute for an explanation.
- The crisis has been caused by “greed”. It is not clear whether this is supposed to refer to a trait of specific people or a characteristic of their behaviour. In either case no explanation is provided as to where such a

trait or characteristic has originated, or why severe, and in particular global, financial crises in capitalism are a scarce thing. Such opinions have more in common with “moralising” than an actual analysis.

- If the crisis first occurred in the financial sector, its causes must be in the financial sector. Taking this line of thought for granted is like saying that the cause of a runny nose is in the nose. Meanwhile, the crisis in the financial sector may have been, but not necessarily was, brought about by causes inherent in that sector.

Any serious empirical analyses of the present crisis should be (and are) of a comparative nature. Meaning that they should examine the present crisis against the backdrop of past crises. Only then can the likely underlying causes of financial crises and of the resultant economic slowdowns be distinguished from random factors.

Serious research into financial crises is centred around three questions:

- What are the causes of a financial crisis?
- How does a financial crisis bring about recession?
- Why do economic slowdowns differ in duration, and in some cases (e.g. in the U.S. or in France in the 1930s; in Japan in 1980s/1990s) take years to overcome?

The second question raises the least doubts. On the other hand, the largest amount of open issues exist with respect to the first and third question, although quite a lot is already known.

A financial crisis is preceded by a credit boom, as a result of which the corporates’ and/or households’ debt exceeds, often unexpectedly, certain security limits, and a slump (recession) follows. Research suggests that credit booms accompanied by climbing asset prices, in particular the prices of real estate, are particularly destructive.

Research into financial crises of the last 200 years has demonstrated that their underlying causes were interventions by public authorities, which in various ways

subsidised the risk taking in the private sector and/or discouraged market discipline (see for example Ch. Calomiris, 2008, 2009). People respond to stimuli – if a stimulus is defective, it leads to a behaviour that is also, judging from the broader perspective, defective. Communism has showed this as clearly as possible.

In similar manner, various studies on the 2008–2009 crisis (see for example de Larosière’s report for the EU, 2008) have identified misguided public interventions as the underlying causes of the crisis.

- Overly liberal policy of the FED, and of many other central banks that followed suit, in the 2000s.
- Political pressure in the U.S. to advance mortgage loans to subprime borrowers.
- Excessive securitisation of bank loans (the so called “originate-to-distribute” model) encouraged by faulty regulations (Basel 1).
- Tax regulations favouring external debt financing rather than equity financing of companies.
- Tax breaks available for mortgage loans.
- The earlier policy of bailing out large financial firms by public authorities, which led to an excessive growth of such firms and, as a consequence, to the “too big to fail” problem. Public authorities became hostage to the effects of their earlier policies.

Such faulty interventions were behind many of the erroneous decisions made at the top of some financial institutions, including the so called search for yield (see for example R. Rajan, 2005, 2009). This is by no means an excuse for the authors of the mistakes. However, from the analytical and practical point of view, it is not enough to condemn them. It is necessary to establish what determines the frequency of such mistakes – and at this point we are coming back to public interventions.

A subsiding credit boom triggers a number of mechanisms that pushes the economy towards recession:

- The overly indebted companies and/or households cut down on their spending. Savings are on the rise, while demand for credit is declining.
- The flagging demand drives up unemployment rates – the more inflexible the labour market, the higher the increase in the jobless rate (compare Spain and the United Kingdom).
- Financial institutions encumbered with bad assets limit the supply of credit. However, the lower growth in new lending may stem from the reduced demand for credit (see above).

There is no stopping of recession mechanisms set in motion by a credit boom that has collapsed. A crisis-response policy may, at its best, mitigate the consequences, but, more often than not, it simultaneously generates costs and poses threats to long-term growth. This is particularly true of an expansive fiscal policy, which goes beyond the operation of what is known as automatic stabilisers. The question about costs and threats created by a very relaxed monetary policy remains open.

The fundamental problem of why in some cases an economic slowdown following the end of a boom took many years, has been the object of intense research. The most recent studies (see for example Cole and Ohanian, 2001; Reinhard, Rogoff, 2009, Shlaes, 2007) strongly suggest that the main source of this phenomenon was different combinations of misguided public interventions. Contrary to what orthodox anti-capitalists may claim, the free market itself generates neither very large booms nor very long economic slowdowns after the end of a boom. In both cases detailed research points out to the hand of a public authority – often invisible to a wider audience.

Faulty interventions included:

- Spiral of protectionism (1930s);
- Excessive tightening of the monetary policy by the FED (the U.S., 1930s);
- Forcing through growth in real wages, cartelisation of the economy, and increased taxation of businesses,

which stifled private investment, especially at the time of F. D. Roosevelt (1930s in the U.S.);

- Politically-driven allocation of credit, which was channelled mainly to large and inefficient companies in order to keep them going, to the detriment of other, more efficient private sector players (Mexico in 1980s; Japan since 1980/1990s);
- Massive public debt overhang, being the offspring of the financial crisis and overly expansive fiscal policy in response to the crisis (the U.S. in the near future?).

The crisis of 2008–2009, just like the ones in the past, has by no means questioned – in the intellectual sense – any major empirical findings as regards the drivers of economic growth of this country. The crisis could undermine economic growth in the political sense, if erroneous interpretations of its causes and conclusions drawn from it take root in the decision-making circles and/or a sufficiently large part of the public. That is why it is so vital to publicly oppose misleading or superficial interpretations of crises in capitalism.

The above mentioned empirical findings include the following:

- Private ownership, separate from politics, is far more conducive to growth than state ownership and political and private ownership. By all means this refers to banks as well. The crisis has shed no new light on this issue. Conversely, it confirmed the threats signalled earlier (see the World Bank), connected with the formal or informal influence of politics on banks. Responsible stress testing of banks should therefore encompass threats relating to their susceptibility to political influence, including that following from direct or indirect state ownership.
- The prevalence of state ownership or political and private ownership condemns a country – in the longer term – to stagnation and a risk of severe downturns. Thus, a dichotomy of fundamental relevance to the economic development is still: state ownership (or ownership that is otherwise politicised) versus unpoliticised

private ownership, rather than domestic versus foreign ownership. There is no empirical evidence (as opposed to presumptions and speculations) that the 2008–2009 crisis has changed anything in this respect.

- Market competition is an indispensable mechanism of innovation and effectiveness of the economy, and hence of economic development. Without, competition private ownership cannot fully exhibit its effectiveness.
- Free (from excessive regulation), and hence flexible markets, in particular the labour market, are important for two reasons: they facilitate a faster switch of the economy to new fields, which fosters effectiveness, and they mitigate the recessionary effects of external or internal shocks.
- Large budget expenditure and, as a consequence, high taxes (relative to GDP per capita), are a systematic impediment to economic growth. The fiscal and so-

cial burden in the now-rich Western countries was much smaller when they were still on their path to wealth than it is now in Poland. All known “economic tigers” (South Korea, Taiwan, Malaysia, Chile, Ireland in 1990–2007) had a much lower level of fiscalism than Poland and/or perceptibly decreasing fiscal and social burdens.

- Significantly limited state authority is necessary to enable existence of economic freedom, market competition, and progressive growth, and to reduce the risk of crises and economic breakdowns.

Limited capacity of the state to take interventionist measures is supportive to economic growth. The larger the activity and efficiency of the state in its areas of operation, which are primarily making good law (just not too much of it) and enforcing it, the larger its contribution to the growth. In this sense describing a limited state as a “night watchman” is just another anti-capitalist caricature.

THE STATE AND THE MARKET. IN SEARCH OF A GOLDEN MEAN.



JAN KRZYSZTOF BIELECKI, CHAIRMAN OF THE ECONOMIC COUNCIL OF THE PRIME MINISTER OF POLAND

Over the two decades since Poland embarked on the path of transformation, its economic landscape has changed beyond recognition. An assertion that Poland has undergone transition from a command economy to the free market does not begin to capture the complexity of the processes or the profundity of changes that have taken place. There has been a profound change in the Poles' mentality, as dormant reserves of entrepreneurship, resourcefulness and resolve have been released on a massive scale. The litmus test of the success of Poland's transformation is the ongoing crisis and the way, quite much unparalleled in Europe, in which we have weathered it.

There are two lynchpins on which Poland's transition has been turning – the establishment of new institutions and ownership transformations. While we may tend to underestimate these factors, Poland's economic miracle would not have been possible without the stable and reliable institutions charged with the role of regulating and overseeing the market, as well as ensuring a smooth flow of economic activity. If we compare Poland to other countries of the region, especially those that have not joined the EU, it is the quality of our economy regulating institutions that sets as clearly apart.

In economic debate there is a broad-based consensus that well-functioning institutions are the foundation of growth. As a country progresses through successive stages of its development, different solutions are called for. At the outset of its transition towards market economy, the basic rules of the game need to be enforced, including the rules of competition. In more mature economic systems, the crucial role of state institutions is to support productivity, innovativeness and entrepreneurship, by creating the appropriate framework conditions.

The other key engine of Poland's transformation, which has been going on in fits and starts over all those years, is the privatisation process. It has attracted to our country the much-needed capital and know-how, which in turn have fuelled the growth of all industry sectors. In the early 1990s, Poland was faced with a dearth of right people, money and time to seriously consider a privatisation path other than quickly finding and luring a strategic investor for a number of enterprises. Back then it was a survival game – and many of the enterprises have survived and are now thriving thanks to a fast influx of foreign investment capital, introduction of effective management techniques and entry into business relations abroad.

Far from being completed, the process remains a major challenge for governments taking turns at the helm. However, when reflecting on the issue right now, we must not lose sight of the current international context, which requires a significant redefinition of the relations between the state and the market. Having lived through twenty years of transformation and having successfully passed the stress test of the current economic crisis, we now find ourselves in a different, much more ad-

vantageous position. This time around, it is the outside world that is putting challenges in our way. We must brave them without playing down their seriousness. It is also paramount that we avoid the herd instinct and respond to those challenges drawing on our unique experience while leveraging the strengths of our economy and our innovative economic policies.

GROWTH FRIENDLY STATE

In pursuance of our prime objective of building a robust and efficient market economy, Polish governments have sold state-owned companies to strategic investors who were able to contribute not only capital but first of all – strong market positions, knowledge and experience. Let us not delude ourselves – it does happen that foreign governments have significant stakes in such strategic investors, seeing that they are often able to submit the most attractive bids from the point of view of a company's growth prospects. I think it would be unwise to adopt a doctrinaire approach and arbitrarily leave such investors out of the game. By doing so, we would sacrifice significant benefits for ideological purity, an approach which hardly ever pays off.

It is true that the Polish state has retained stakes in more than 700 companies and that the number is far too high. It cannot be denied that exercising effective supervision over such a host of businesses is not possible. However, it is never a good idea to pursue privatisation plans for their own sake. The role of the state is not to get rid of its valuable assets as quickly as possible, but to apply them to the most profitable uses. In this respect, the state should behave like all private owners. Businesses which are faring well on the competitive market could be supported by introducing proven standards of corporate governance, such as transparency, measurable indicators of success and personal accountability for the firm's performance. We must not let political considerations influence business decisions, but that need not involve a sell-off of income-yielding assets. Poland's situation is specific in that, more often than not, the only way to privatise the largest enterprises is to secure a foreign investor. This is due to the fact that there are still few actors in Poland who would be able to raise enough funds to foot the bill – even pension funds do not yet have sufficient resources. This is not

to say that foreign stands for “worse” and Polish stands for “better”, but the recent crisis has belied the notion that capital has no nationality.

The banks affected by the crisis on their home markets have restricted lending on the markets where they maintain daughter companies, so as to mitigate systemic risks for their head offices. The situation is described in the IMF's Regional Economic Outlook for Europe, which shows the scale of the decline in the supply of credit provided on the CEE markets by banks whose head offices are located in the West. In many cases, the local subsidiaries were cut off from funds and had to rely exclusively on client deposits. As changes in the flows of capital ran to a dozen or more percent of GDP, the IMF, together with the European Bank for Reconstruction and Development and the European Commission, stepped in to help solve the problem. Thanks to those measures, we have luckily managed to avoid a run on the banks, but increased instability and the related risk have become a grim reality.

At the same time, we have already reached a stage of development where we are able to compete head-on with our European competitors. We have well-educated management staff with proven track records, whose performance is starting to gain recognition. Looking at the managements of large firms, we can see that the location of the head office is not an irrelevant factor. The selection of management staff and investment in its development is, unfortunately, not geographically neutral. So it is a good thing that we have a growing pool of intellectual capital that Polish businesses can tap into.

Similarly, in the case of bail-out packages offered in recent years to companies teetering on the verge of bankruptcy, there have been pressures to preserve the jobs on domestic markets and look for savings at foreign subsidiaries. While these have remained largely empty threats, they do make you think. For civilisational and developmental reasons, it is desirable to prevent a situation where Poland would serve as a mere distribution network for large conglomerates. Instead, it should be able to keep head offices here and be a hotbed for businesses expanding onto the European market and beyond. The problem had first come to

light before the crisis struck, when the creation of certain pan-European institutions, for instance in the banking sector, was contemplated. This led to the establishment of entities “too big to fail”, mirroring the problem which first affected the US. Likewise, the energy sector saw the consolidation trends gain momentum. In the aftermath of the crisis such trends will inevitably be checked, to prevent the risk that giant continental institutions, especially banks, would pose a threat to overall economic stability. However they will not disappear altogether. To position ourselves comfortably in that European and global landscape, we need to be gaining strength, to make key Polish firms attain critical mass.

This has nothing to do with the creation of state “champions” or leaders artificially selected on the basis of political criteria. Therefore, rather than scuppering the chances of Polish firms, we must create conditions conducive to their growth, irrespective of the ownership structure or industry. The challenge which Poland and its successive governments are faced with is to create conditions under which future generations will be able to prosper. Echoing the words once said by Margaret Thatcher, we must give our successors a chance to reach high or even higher.

CLASSIC DISPUTES AND LESSONS TO BE DRAWN

While presenting a range of new challenges, the current crisis also presents an opportunity to look at the past from a novel perspective. First of all, Poland is not an island – we need to draw on the best solutions worked out by other countries and watch our partners cope with the crisis. We should also draw lessons from history and the previous economic meltdowns. The past century witnessed an intense debate about the relations between the state and the market. In reflecting on the issue, we need to lean on solutions that have proved their merit, without placing too much confidence in any doctrine, be it liberal or statist. Finally, we need to audit the entire sphere of the state’s intervention, to identify areas where it delivers the best results and those where it had best be shed.

Starting with the capital of past experience, let us look at the present crisis against a broader backdrop of economic history and the main schools of economic thought

developed over the past century. Amid the developments stemming from the current crisis, which often take quite dramatic turns, a debate has been ongoing between the proponents of short-term economic stimulus and long-term equilibrium, started in the inter-war period by Keynes and Hayek. While both sides have staunch advocates who do not change their views depending on circumstances, in the successive economic “showdowns” one or the other side have got the upper hand, and each such transition was marked by violent tensions.

Every momentous event in the world’s economic history has challenged the accepted dogma, prompting questions about a new conceptual and ideological framework. Thus, the Western world has passed through Keynesianism and the New Deal, to Reaganomics and Thatcherism, expecting history to end with the entrenching of the so-called Washington consensus. But every modification, largely in response to some current problems, would breed solutions that in the longer run overturned the system. The laissez-faire philosophy preceding the Great Depression, the inflationist policies pursued by governments inspired by Keynesianism, the anti-statism and confidence in market deregulation – each of these policies would initially spur short-term growth, but in the longterm would end in crisis and self-annihilation.

Historically, capitalism has taken several different forms. In its first version, the imperative was not to suppress the freedom of the market in any way. As the world had emerged from the Great Depression, it acknowledged the interdependence between politics and economy while governments assumed responsibility for macroeconomic management and development of key industry sectors. This “mixed” economic model was behind the western world’s biggest civilisational leap forward and the inclusion of an overwhelming majority of Western society in economic growth, on a scale previously unheard of. The dream of a welfare state ended in a rough awakening with the outbreak of the inflation and economic slowdown of the 1970s, which prompted Ronald Reagan and Margaret Thatcher to return to the source of market thinking. A number of statist solutions which hampered economic activity were then revised. As a result of that move towards greater liberalisation, the financial sector began to

flourish, which initially improved access to financing both for the corporate sector and ordinary people. However, certain mistakes made while establishing the regulatory regime, which must be stable and adequate in line with an old liberal rule forged by Adam Smith according to which freedom requires responsibility and self-control, culminated in the current crisis. The question we are dealing with, in this context, is about the philosophy of social attitudes. Market fundamentalists believe that the fewer constraints on the natural human pursuit of self-interest, the better. They believe a market left to its own devices works efficiently, compelling its participants to make effective decisions through the price system, which provides an insight into the future. In their eyes, a crisis is a mere correction of the system which simply needs to be ridden out and which must hurt even those who have fallen its unwitting victims. Therefore, they frown on any state intervention aimed at alleviating crises.

WHAT DOES THE CRISIS CHANGE?

The present time marks another watershed for the Western world's economic order. In the past fifty years, we have seen nothing comparable with the scale of the ongoing crisis. The world's GDP has fallen by an average of some 2%, but in the mature Western economies the decline has been even more acute – running to as much as 4%. The annual decline in trade has reached around a dozen percent, while unemployment rates across major economies have skyrocketed – in the US from 4.6% to over 10% (a higher level in the entire post-war period was only recorded in the early 1980s), and in some economies – as the housing bubble burst – to more than 20%. As for developing countries, they seem to be coping much better. Despite heavy reliance on exports, they have maintained fast-paced growth – over 9% per year in China, over 5% in India. The countries appear to have learnt the lessons taught by the crisis that visited them towards the end of the 20th century.

The crisis has also thrown in sharp relief a complicated network of interconnections between the individual spheres of economy, as well as between countries and continents. The ideology of liberalism, free market, free trade and free financial flows has come under severe test. Amid the general rush to frame a new economic order,

many pin the blame on the unfettered free market, which leads them directly to the conclusion that there is a need for extended state intervention. Paraphrasing Richard Nixon's words, many governments have concluded that we are all Keynesianists. Doctrine is one thing, but the practical experience of individual countries and economies is quite another. In many cases, the way in which a country is responding to the present crisis is not grounded in a set of established beliefs, but in lessons drawn from previous crises and economic turmoils. Historical memory is never as clear-eyed as during hard times. This explains why the steps taken by the US administration in the face of the present crisis are informed by everything that happened during the Great Depression of the 1930s. Likewise, the Germans are keen to avoid at all costs an economic scenario along the lines of what they so painfully experienced at the time of the Weimar Republic. This is the root of the debate between the two countries, on the G20 forum, as to how state institutions should best respond to the crisis. The Americans are bent on deploying a number of monetary and fiscal stimuli to restore consumer demand, whereas the Germans think the key lies in fostering the economy's competitiveness by reducing public debt, especially in an ageing Europe.

If a change in economic policies is to be anything more than a makeshift fix to current problems, with the use of old tools to boot, then we need to carefully examine the mechanisms of the current juncture and the challenges that will confront governments in the future. We could point to at least three factors distinguishing the present situation from the other turning points punctuating the most recent history of capitalism. Firstly, the role of the state in the economy has grown to levels never seen before, notably in countries which profess – at least in theory – the strongest commitment to liberal ideology. One area where this trend is blatantly manifest is the government spending to GDP ratio. In the US, paradoxically, the ratio has been on an upward trajectory since the beginning of George Bush's presidency, gaining further momentum once the crisis set in. It has gone up from 33.9% at the beginning of the decade, to 36.7% in 2007, to approximately 42% now. In the UK the ratio is at its post-war high of over 51%. In the largest countries of continental Europe, by contrast, changes have not been

that spectacular (in Germany and France – the ratio has risen by 3%-4% pp, which is below the all-time highs), while in most OECD countries, thanks to the curbs put on public spending in the 1990s, the current situation resembles that of more than a decade ago.

Secondly, the world has seen a build-up of significant imbalances, further compounded by a massive use of financial leverage, which – given its scale – has led to the risk of a knock-on-effect, as the collapse of one market may now easily bring on the collapse of another. Thirdly, the race for the lead in the global economy has been joined with full impetus by certain Asian countries, which have their own values and methods. The sphere of their economic influence has extended beyond their own continent, to Africa, South America and, more recently, Europe.

The observed and forecast expansion of the state's role in the economy can be attributed to a number of factors. First of all, many Western states came to believe that it was possible to maintain and develop the infrastructure of a welfare state, guaranteeing a rising level of education and health care services for all citizens. Even the recent US administrations led by the Republicans, who are traditionally opposed to an expanded role of the state, stepped up public spending, also on the health care sector. It has turned out that, paradoxically, in many areas Poland has been a more ardent believer in and – what is more important – follower of the unadulterated doctrine of free market than countries traditionally associated with it, such as the US.

While the privatisation and outsourcing of part of public services have allowed us to rein in government spending, the trends may reverse in the coming years. Governments may soon be confronted with the issue of ageing populations and sharp rises in spending on health care and pensions. It is already evident that even in countries which are not shying away from bold reforms of public finances, the health care sector is protected from cuts and will eat up an increasing portion of GDP.

An expansion of the state's role is a phenomenon witnessed globally, especially in emerging countries. Among the global business heavyweights, there are more and

more state-controlled companies, since states use strategic businesses as platforms for global expansion. A number of today's market leaders relied on state support when taking their first steps. Finally, a frenzied race is on globally for energy resources, which often remain under sovereign control. All this goes to show is that states are actors to be reckoned with.

However, a decisive driver behind the current, unseen at the time of peace, level of government spending to GDP, has been the anti-crisis measures implemented by many governments over the past two years. What the statistics reflect are mainly funds spent on the nationalisation or bail-out of failing enterprises. In the ill-regulated market, a number of businesses had become “too big to fail”, meaning that their collapse might have devastating consequences for the entire economy. But that is not all – owing to a massive scale of state guarantees for banks, national governments have gotten caught up in commitments running to several dozen percent of GDP, which are, much harder to capture by official calculations. In the banking sector, the state has become “the banker of last resort”.

REMODELLING OF STATE-MARKET RELATIONS

It is important to note that this process will eventually grind to a halt. The crisis now afflicting the euro zone is a telling illustration of the dire consequences of lopsided government policies. Crisis exit strategies are now in the workings aimed to restore deficits to previous levels and bring the debt spiral under control. A new socio-economic model is taking shape before our eyes, a model that may dominate for many years to come. However, we must not ignore the lessons from the past which teach us that – in addition to seeking a cure for current economic ailments – we must plan ahead, so that the foundations laid down now would not precipitate another collapse in the future.

To that end, a range of systemic changes are being introduced, including a reform of the financial market regulation known as “Basel III”, a deepening of the economic policy coordination across the EU (e.g. the European semester and a change in the method of enforcement of the excessive deficit procedure), and a strengthening of financial watchdogs' powers. The first reform is intended to counteract the formation of speculative bubbles, inflated by too

easily available credit and misuse of financial leverage by banks, which was one of the reasons behind the outbreak and vehemence of the current crisis. The other two reforms address the structural deficiencies of the euro zone, which does not have a common fiscal policy or an appropriate mechanism for coordination and surveillance of undesirable trends and developments in the financial sector.

Another factor, absent during the landmark moments of the past century, is to do with the stiffening competition from developing countries, notably from Asia. Their socio-economic system is based on premises different from those which we are used to in the Western world. It may be known under different labels – the Beijing Consensus or state capitalism – but it admittedly represents a tempting alternative to the solutions proposed by Western governments. In that system, the free market is not coupled with democracy and state-owned companies. Companies are dependent on the state administration through a network of licences and regulations, and are a dominant economic force. The competition between the two dissimilar systems is raging before our eyes and is encroaching into areas that have so far been reserved for Western economies. Notably symbolised by the recent takeover of Volvo by Chinese carmaker Geely, as well as the global expansion of Chinese capital. Another important factor is the fact that Asia has proved to be much more resilient than the Western world in the face of the crisis. Changes in GDP have been less dramatic there and even China – which is so heavily reliant on exports – has successfully averted the risk of a slackening growth. As a matter of fact, the only major challenge faced by Asia has been a fall in demand from importer states, an external shock rather than crisis generated by an inherent weakness of the Asian economy.

In this situation, Western states need to include the new players in expanded international management and cooperation structures. A step in that direction has been the shifting of global economic governance from the G-7 to the G-20. The process of giving China and other countries more say in the decision-making bodies of the IMF has started, while the role of those countries in the UN Security Council is now under discussion. For the changes to deliver a desired effect in increasing the world's stability and creating a truly inclusive economy, the developing

countries must demonstrate greater willingness to shoulder the responsibility for our shared global problems.

The processes will have a bearing on the reforms of capitalism and the shape it will eventually take in the 21st century. As the third player joins the game, the existing logic will change due to the addition of a new reference point. The “how much state in the market” debate will be taken to a whole new level, this time with a broader theme to the relations between the market and state institutions and the role of business in furthering political goals.

WHAT KIND OF STATE? WHAT KIND OF MARKET?

Taking into account the two trends described above, as well as long-term expansion of the state's role in the economy with a concurrent need to contain soaring debt, we should now answer the question: what kind of state do we need the most? In which areas are the state's functions discharged in the most efficient way and what do we expect from the state?

In today's economic universe, the notion of common good encompasses broadly defined infrastructure – ranging from technical assets (such as roads and power lines) to less tangible ones – including a legal and regulatory regime (which is not influenced by the market), as well as education and health care. Entry into those areas requires huge investment and an incurrence of fixed costs, but their subsequent operation, measured as the marginal cost per each new user, is either cost free or low cost. This is the natural domain of the state, where it steps in with its administrative apparatus and financial resources to give the economy a space to grow in. The significant entry barriers also require the state to enact pertinent regulations that would ensure equal access to the infrastructure by all market participants. Even if the state relinquishes direct control over those areas, it has to prevent monopolistic practices (or break up natural monopolies) and, last but not least, preserve the existing infrastructure for generations to come.

Consolidation is welcome both on the side of revenues and expenditures, but it is key to discern a difference between consumption spending and pro-growth spending. This is particularly relevant in the case of education. When asked

about the sources of his country's success, former Finnish Prime Minister Esko Aho said repeatedly: "education, education, education". He could not have been more right. If greater outlays result in a higher quality of education, they are worth making, even at the expense of substantial savings and self-denial in other areas.

A well-defined role of the state in the economy should offer a solution to the nagging issue of how to deal with enormous budget deficits and what strategy to adopt in order to reduce sovereign debt. Any straightforward slash in spending and rise in taxes will prove counter-productive, as it will only slow down growth and put off the solution of the problem. While in most countries the level of public spending should definitely be brought down, especially in the face of the demographic shifts mentioned above, we must not cut it down in a random manner. Obviously, we need to find out which systems or which elements of the country's economic infrastructure can work efficiently and yield profits under state management, and which would probably work better under private management. Moreover, the state does not need to surrender all control – there are a number of working solutions in various parts of the world where a common good is managed by a private owner. The key is to establish a set of rules and conditions which the private owner has to comply with. These may include an obligation to maintain existing connections (in the area of transport) or a pre-defined level of specific indicators (in the area of education and health care). If the state, which currently accounts for more than 40% of GDP, is to function effectively and make profits rather than losses, an audit of the infrastructure's effectiveness will be a prerequisite.

The state also has a duty to provide for future generations. This end cannot be achieved, though, without a fair deal between the generations, defining the mutual rights and obligations of the respective age groups. The deal must guarantee decent pensions for those who have earned them. On the other hand, it needs to support rather than stifle economic growth, by providing opportunities for the younger generations, which – as proved empirically – tend to be more innovative and thus must not be hindered in their aspirations.

While the burden of debts incurred today will be inherited by future generations, it needs to be remembered that not every debt has equal weight. So instead of seeking to minimise debt in general, we should focus on reducing that portion which is used to finance current consumption, while leaving intact the investment expenditures, thus increasing the wealth of succeeding generations. Such an approach is not tantamount to stimulating short-term demand, along the lines proposed by Keynes and his following. It is in a way an indirect approach – a middle ground between unqualified belief in the market and its ability to self balance, and hope that the state can provide a demand stimulus without regard to its long-term impact. It is not grounded in any ideology but a down-to-earth analysis of both present and intergenerational costs and benefits.

Looking at the politico-economic landscapes of individual countries, we can spot the harbingers of imminent changes. In the UK drastic budgetary cuts are accompanied by a redefinition of the relations between the state and local communities, as well as the state and individual citizens. In this case, the underlying tendency is to return to the liberal principles based on confidence in, and devolution of some powers, to individuals. A reduction in the budget deficit is to be achieved mainly through austerity measures, rather than rises in public levies. In the same spirit, local communities are to gain much more autonomy, be it in running and managing schools or in appointing local chiefs of police. This demonstrates that the system can easily adjust itself to new challenges and circumstances. We need to return to square one. Citizens will need to take over part of the state's functions, provided that they are capable of doing so.

The crisis, which has highlighted the need for a short-term increase in the state's involvement, may paradoxically result in the state's ceding some of its role in the economy over a longer term. It can, and indeed should, lead to policy rationalisation, scrupulous cost and benefit analysis and bold implementation of fresh, innovative projects. Although the end of the current crisis of economic liberalism seems to be close at hand, that does not mean that in future we are to place ourselves unreservedly under the protection of the state – at least not the state as it is now. The state will have to be a new state

and the marketplace will have to be a new marketplace. While, the state will not altogether eliminate uncertainty, it will have to manage it in a more efficient manner.

NEW MODEL OF CAPITALISM

There is no doubt that we are now witness to a metamorphosis of capitalism, both in response to the crisis and as a correction of all the inadequacies and abuses which had been piling up before the onslaught of the crisis. Had it not been for the collapse of Lehman Brothers and the process it triggered, pathology in the financial markets would have festered on for more time. Many more citizens would have come to the conclusion that, owing to historically low interest rates, only the sky was the limit of what they could afford, while the debt load would have grown by further billions of dollars and euro.

The newly emerging model of capitalism will have no precedents in history, as its previous versions were not exact carbon copies of their predecessors. It is set to be a “mixed” model, where no one will put unconditional trust in the markets and everyone will closely watch the government’s moves.

As for the government, it will be a sort of underwriter, a guarantor of economic continuity or – if the worst comes to the worst – a guarantor of survival. Like all insurance institutions, it will seek to mitigate its systemic risks, by avoiding projects which look doomed to fail. Accordingly, the idea of “a protective state” will be re-thought, as efforts will focus on more effective ways of doing things, where the involvement of the state and citizens will complement each other. This will put an end to entitlements and hand-outs given to some groups at the expense of others.

The state will seek to tackle the huge inequalities that have developed in recent years throughout the Western world, although it will not use erstwhile methods to do so. The fishing rod will now come with a price tag attached. The repayment may be comfortably scheduled over a long period of time and part of the price may be repayable in kind, but it will inevitably be enforced.

It will be also made clear that it is the government in its role of guarantor which determines what kind of ac-

tivities pose a threat to the state’s economic stability. If there are designs to establish oversized banks, or if too many citizens are tempted to take out overly cheap credit, or if the stability of the market comes under threat, the state will have to intervene promptly and effectively. At the same time, it will have to frame a system that would make all market actors share in the risks and costs.

This spells greater responsibility on the part of those who govern the country, but also on the part of the market, which will need to reposition itself as a monitor of the state. Thus far, it has not fulfilled that role well enough. In the first years of the common European currency, the market completely neglected its task of assessing the risk and creditworthiness of individual states, jumping to a premature conclusion that the euro zone was a homogeneous economic area. Now it has realized for itself that it cannot afford to make the same mistake again.

The state must rein in spending, without losing sight of its rationality. Even after historically draconian spending cuts, the state will still have huge funds at its disposal, which it should astutely spend on spurring economic growth and pro-growth projects. At the same time, it must continue to manage social expectations, which were snowballing from the 1950s onward, culminating in the economic crisis of the Western civilisation and shattering the post-war economic consensus.

Additionally, the state must find ways to stimulate innovation, a major challenge that Poland still has to address. Without innovation, we cannot expect any sustainable growth in the economy’s output. For some time still, we can continue to grow on the strength of our competitive advantages, but that potential will exhaust itself as years pass by, if are not well placed to take the lead. To this end, we would need solid framework conditions designed to encourage innovation, as well as a demand stimulus from the state.

To regain its moral and ethical dimension, capitalism would need to return to the basic values on which it was originally founded. It would need to engender a greater number of “capitalists”, that is to say persons who are its active participants. The trend involving a kind of “Wal-

marting” of capital, which has been seen in recent years, does not hold a recipe for long-term success of capitalism.

From our point of view, the timing of the re-orientation of the state’s role in relation to the market, which is now taking place throughout the Western world, could not have been more opportune. We are not forced to make any radical and painful ad-hoc decisions in order to survive.

Instead, we can carry on a discussion about our future development. Taking advantage of this apparent comfort, we should redefine the synergies between the state and the market, drawing on our own experience and that of other countries. We have the advantage of not being forced to discuss what the state and the market should be barred from doing, which means that we are able to reflect more positively on a new “state-market” paradigm.

THE STATE – MARKET TANDEM MAKES SENSE



JACEK KRAWIEC,
PRESIDENT AND CHIEF
EXECUTIVE OFFICER
OF PKN ORLEN

Over recent decades, Poland has grown into a modern, vibrant and fast-growing economy. Compared with 20 years ago, it has transformed into an entirely different economic system. Once a bold privatisation was undertaken, the business environment was liberalised and new businesses were created. Poland saw a veritable explosion of entrepreneurial spirit – nowadays it has 47 micro enterprises per every 1000 residents, compared with only twenty in neighbouring Germany. As societies initiative was unchained on a massive scale, Poland was the first among the transition economies of the 1990s to overcome recession and achieve a robust rate of growth. Based on the International Monetary Fund’s statistics, Poland’s GDP at constant prices grew over twofold between 1989 and 2009, to PLN 1,049bn. GDP at purchasing power parity per capita – went up by over 80%, to USD 18 thousand during this same period. Poland has now joined the elite club of the world’s 20 richest economies. To date, seven and a half thousand state-owned enterprises have been privatised, fetching the State Treasury more than PLN 100bn in proceeds between 1989-2009. Currently, there are fewer than fifty firms wholly owned by the state that have not yet undergone any ownership changes.

THE LIMELIGHT IS ON POLAND

The time is now if we want to promote Poland’s global economic presence. First, because we are among the top high-

growth European economies. Secondly, we are soon due to come under international spotlight when we take over the EU’s presidency next year. With it, we will get a rare opportunity to focus the world’s attention on our priorities, but also – which is perhaps more important – put in an impressive appearance on the international stage as a well-functioning, innovative and go-getting society. Another chance to promote our country, albeit on a different arena, will be the European Football Championships that Poland will co-host with Ukraine in 2012. Over the next two years, our country will be all over the headlines.

As of the end of 2010, the cumulative value of direct foreign investment into the Polish economy will have exceeded USD 110bn, making us the region’s largest beneficiary of investment funds. The influx of foreign capital has led to the creation of more than a million jobs. Nevertheless, it is not only new factories that are being built; a smashing hit of recent years have been BPO (Business Process Outsourcing) centres. Furthermore, having started out as an outsourcing hub for fairly simple accounting, payroll and IT services, we are gradually becoming more of an R&D hub, as an increasing number of companies choose to relocate their R&D centres to Poland. In recent years, some of the really big business names have launched their knowledge centres here, including Google, IBM and Intel. Other well-reputed firms, such as VW, Pratt&Whitney, GE or Samsung, have their research units in Poland.

The managing director of Goldman Sachs International, Selim Basak, recently noted (highlighting the uniqueness of Poland’s economy) “the CEE region has ceased to be seen as a monolithic whole in the wake of the crisis, and other countries are now trying to figure out how to replicate the Polish miracle”. Martin Oxley, CEO of the British-Polish Chamber of Commerce, stressed that the reason why foreign firms looked to expand in Poland again this year, in

addition to its being an attractive local market, was the fact that it provides an ideal platform for further expansion into the rest of Central Europe.

CORPORATE SECTOR AND NEW SOURCES OF GROWTH IN EUROPE

Like all other EU members, Poland needs to look hard for new sources of growth that will give it a leading edge in the new economic model that is taking shape in the aftermath of the crisis. Europe's current economic ailments are related to stagnant or contracting growth, which in turn results from the fact that many Western European countries have lost their ability to compete in the global marketplace. In this challenging environment, Poland is faring exceptionally well. According to the European Commission, in 2010 the rate of its economic growth as captured by GDP should be among the highest in Europe, at around 3.4%. A steady stream of EU funding and currency flexibility have helped Poland navigate the crisis relatively unscathed. These encouraging developments are very important, given that recessions usually erode an economy's social capital and make companies much more risk-averse. Nonetheless, we should not let them beguile us into abandoning in-depth reflection on what kind of long-term growth strategy Poland should adopt.

A major challenge which needs to be addressed is to improve the innovativeness of Polish businesses. In the European Innovation Scoreboard of 2009, Poland was ranked 23rd among all EU countries. We tend to perform relatively well in terms of human resource measures. For example, the "quality" of Poland's manpower has been rated at 83% of the American level. However, according to Eurostat's data, the EU-average R&D spending stands at 1.84% of GDP, but in Poland – it is a paltry 0.56% (EUR 1.5bn). By comparison, the corresponding figures for Germany and Sweden stand at 2.53% of GDP (EUR 59bn) and 3.73% of GDP (EUR 12bn), respectively. The proportion of innovative firms in the EU is 51%, versus 16.9% in Poland. Another measure of an economy's innovativeness is the number of patent applications filed. According to statistics released by the European Patent Office, the country which holds the lead is Germany – whose citizens in 2009 filed more than 25 thousand applications to have their inventions patented by the EPO,

compared with only 173 applications from Poles. It needs to be noted that countries which have historically recorded the most spectacular success in economic convergence (such as Ireland) stepped up investment chiefly in high-tech areas, while laying strong emphasis on workforce education, in order to leverage the potential of the modern economy. It is vital that Poland avoids the mistake of focusing exclusively on infrastructure investment, which should be complementary to investment in high technologies. In addition, we need to be aware of our key strengths, using them – to the largest extent possible – as the foundation on which to build a strategy of realising our country's potential. Success in encouraging innovation will require governments and entrepreneurs to work hand in hand at many different levels. From education, to infrastructure development, to tax incentives, to pro-innovation public projects, to the regulatory regime. All these elements must be effectively orchestrated to generate innovation advances. The ongoing crisis may offer a chance and a stimulus to seek, and lay solid foundations for, new sources of growth in Europe.

POISED FOR EXPANSION

As a member of the European Common Market and the global economic system, Poland is progressively opening up to international competition. From the point of view of Polish businesses, the first six years since we joined the EU have been an undisputed success story. On the other hand, we should not regard Europe as our "ultimate frontier" market. Polish firms should be able to compete with the world's giants, but to do so successfully we should nourish our own home-grown global players. Large and powerful businesses capable of successfully challenging their foreign rivals will primarily need a solid footing in their home country, in the local regulatory and legal regime. Let us consider the energy sector. I am proud to say that PKN ORLEN has taken full advantage of the opportunities offered by free Poland. Few people may remember that the company was established only 11 years ago, through a business combination between Poland's largest refinery Petrochemia Płock S.A. and largest retail network CPN S.A. – a merger whose scale was then unmatched on the Polish market. In 2002, PKN ORLEN started to expand beyond the boundaries of Poland. Within just 10 years of its establishment, it became the

largest enterprise in Central Europe (in terms of revenue, which amounted to nearly PLN 70bn). In the prestigious Fortune500 ranking, PKN ORLEN, as the only company from Poland, has been ranked 398th.

It is safe to say that PKN ORLEN is the first Polish company with truly international operations – roughly 60% of its total revenues are generated outside Poland. None other Polish business can boast as much experience in international expansion, which PKN ORLEN embarked on in 2002 with the purchase of a chain of filling stations in Germany. In the following years, we also staked claims on the Czech and Lithuanian markets, starting to consolidate the CEE refining sector. Year after year, our achievements have gained recognition of both domestic and foreign organisations – this year, for example, PKN was named Polish winner of the “Best Managed Companies in CEE 2010” ranking, organised by UK financial magazine Euromoney.

However, Poland needs many more internationally recognisable flagship firms and brands which will be reckoned with by competitors from their respective industries abroad.

NEW FINANCING OF GROWTH

The structure of financial investments, derivative instruments and methods of financing and securing debt, as exposed by the current crisis, has turned out to be more outlandish than many analysts could have ever imagined. The fact that loans were not collateralised with real assets but secured with other loans, which in turn were backed by other loans, muddled the picture so much as to make risk assessment virtually impossible, pumping up speculative bubbles. Even rating agencies tagged along with that trend – instead of being judges of the riskiness of investments, they would give strong ratings to trash securities.

One of the steps towards solving the crisis is a massive “deleveraging” of companies, financial institutions and households. The process has already started in the US, where the magnitude of the problem was the greatest. Between 2007 and 2009, the debt load of US households fell by over 4%, whereas that of the corporate sector remained basically flat. To compare, between 1999 and

2007 the debt levels in the two sectors rose by 59% and 21%, respectively. This process still lies ahead for Europe, with an added challenge due to the lack of accurate estimates of financial needs. The situation has resulted from the access to credit being too readily available in previous years and the development of financial derivatives markets. Even though Europe was less heavily indebted before the crisis started to unfold, over the past two years the rate of debt growth has been almost completely arrested. The problem of excessive leverage has also affected PKN ORLEN. Its ambitious business growth strategy has been implemented at the expense of high debt levels and a weakening of the company’s financial position. In 2000-2003, PKN ORLEN’s debt amounted to PLN 2.5bn, in 2006 it rose to PLN 7.7bn, having hit PLN 12.6bn at the end of 2008. Following a number of optimisation measures, within just two years the company has managed to reduce its debt to PLN 9.9bn (at the end of the third quarter of 2010), while leverage has fallen to a relatively safe level of 42%.

I believe that going forward the corporate sector will need to reconsider its approach to investment financing and return to “plain vanilla”, and thus more transparent, methods of raising debt finance for business activities. Debt leverage, exotic multi-dimensional derivatives and obfuscation of accounts will need to go. Consequently, the strategy of “buying growth with debt” will be restricted to borrowers and lenders alike.

The same applies to public finances. In recent years, since the crisis broke out, a growing number of states have been struggling with fiscal problems and the risk of defaulting on their debts. In 2009, the average budget deficit across the EU-27 area stood at -6.8% of GDP (with records having been set by Ireland and Greece, at -14.3% and -13.6%, respectively), while sovereign debt ran to 73.6% of GDP (with the highest ratios posted by Italy and Greece, at 115.8% and 115.1%, respectively). To compare, Poland’s budget deficit in 2009 ran to -7.1% of GDP, while its public debt reached 51% of GDP. Additionally, the risk of default by certain European states remains a distinct possibility. In this context, I think it is time to return to the traditional European virtues of hard work and thrift. Accumulated savings should be

the basic source of investment, as well as a catalyst of economic growth and a nest egg to make up shortfalls in “lean years”.

THE STATE-MARKET TANDEM

The crisis has laid bare all weaknesses of the global economic system, including inadequate regulation of the financial sector and a distorted structure of incentives. Once the world finally shakes off the recession, we will be confronted with the task of reinventing the rules of the game, free of the errors that have culminated in the current debacle. At the same time, we should not subscribe to the orthodox views which put the state in opposition to the market. According to the article authored by former prime minister Jan Krzysztof Bielecki, a new economic model will need to draw on what is best in the two major economic traditions – statism and free market – while rising up to the challenges of the future.

An ideological bias manifests itself, for instance, in a tendency to indiscriminately sell off state-owned businesses. More often than not, such policies are prompted by ideological purity, rather than economic calculus. That is an unreasonable approach. In fact, the key consideration should be business performance, rather than an attempt to achieve a balance between public and private ownership. Many industries in which the state retains equity interests boast strong performance and effective management, PKN ORLEN being a case in point.

Assessing the privatisation processes in Poland and comparing our country with the rest of Europe, we cannot help but conclude that today there is no rationale whatsoever for the state to surrender all control over some enterprises, particularly those of strategic importance for the state’s security or economic vitality. There is a strong case for the state to retain some interest in the industries which deal with energy, fuels and critical infrastructure. Such a policy will be in keeping with a long-standing European tradition, as well as broader international trends. Businesses wholly or partially controlled by the state are important actors of the global economy. They are able to actively expand, which – especially in the energy sector – allows them to diversify the sources and routes of supplies, achieving sustainable conditions for growth. For

this reason, I cherish the concept of national business champions, such as PKN ORLEN, with a strategic role to play in a country’s economy. Despite the spectre of privatisation that was sweeping over the world from 1970 until 1990, the governments of individual states retained significant stakes in many companies. For instance, in order to forestall attempts to take over French energy company SUEZ, the government in Paris decided to merge it with state-owned Gaz de France. The move led to the creation of a national giant that was out of foreign investors’ reach. Other examples of companies owned by the state include Statoil, Eni and Enel, which – in addition to ensuring the energy security of their home countries – bring their owners (including the state budget) billions in profits.

It cannot be denied that currently many firms benefit from a government leg-up in their expansion onto foreign markets, either through trade treaties or support in disputes related to unfair competition. It is a win-win situation. As fast-growing businesses increase employment and production, while educating the future workforce and a new generations of managers creates a valuable resource to be harnessed by their home countries for many years to come. This is not our local speciality. In the old EU countries, including France and Germany, the governments clearly favour domestic players, whether or not state-owned. It is no secret that Germany’s government champions the interests of Deutsche Bank or Commerzbank, while Credit Agricole and Societe Generale can count on the French state’s support not only during crises. Similarly, the Czech state is partial to its flagship CEZ, while the Hungarians protect MOL.

That being said, it is important to know where to draw the line on such support and dependence. The interests of any single business must never take precedence over the interests of the state or conflict with the interests of the EU and its Common Market. Over the last two years, there has been a need for massive state intervention in the economy across Europe in order to rescue some large institutions from failure. Moreover, the search for measures to stem the crisis has revived the lure of protectionism, at least in its soft version of encouraging firms to maintain jobs at home at the expense of foreign subsidiaries. An example worth noting was a financial injection

of USD 50bn to General Motors (ever since dubbed as “Government Motors”), which the Obama administration did not hesitate to offer the distressed carmaker. Was that intervention successful? Was it at all necessary? It is difficult to tell at this point – we should wait and see what condition the company will be in in another one to two years. It needs to be stressed, though, that there should be no green light for state intervention, unless in an absolute emergency, since it may undermine competition and eventually harm consumers.

POLAND IS STRONG WITH THE STRENGTH OF ITS BUSINESSES

The world is currently going through a series of upheavals and radical transformations, of which a major one is connected with the need to re-define the state-market relations. Poland is taking part in these transformations as one the world’s 20 largest economies. Polish busines-

ses are solidifying their domestic position, while looking to expand more actively beyond Poland. Names such as PKN ORLEN are now widely recognised abroad. For us the ongoing crisis is primarily a chance – to take advantage of the emerging opportunities, to identify niches that remain to be exploited and to capitalise on our growing position on the European and international arena. It is crucial that we draw on the experience accumulated during the transition period and the current crisis to build a sound partnership between business, with its pool of entrepreneurship and talent, and the state, with its powers to set an effective regulatory regime at home and its muscle to champion our interests abroad. It will give Polish companies a solid springboard for foreign expansion. However, for our success to be consummate, we need strong flagship companies, embodying Poland’s success and entrepreneurship.



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