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Poland: Limited Options in the Debt Dilemma

Summary

Poland's recovery from its economic crisis of the early 1980s has stalled, and prospects for sustained improvement over last year's disappointing performance appear slim for the rest of the decade. As a result, Warsaw, Western creditors, and the USSR will find no escape from the dilemma posed by Poland's economic weaknesses:

- Failure to give the workers some say in determining their political destiny or to meet consumer demands with increased supplies will leave the Jaruzelski regime saddled with a sullen and unproductive labor force. Although the regime's use of force and intimidation may maintain a superficial calm, continued economic problems will erode the more enduring political stability that the regime is seeking.

- Even under optimistic assumptions about Poland's hard currency trade performance, Warsaw will make little progress in meeting its financial obligations. Western creditors face more years of debt reschedulings, missed payments, and pleas for new credits from the Poles. [redacted] 25X1

This memorandum was prepared by [redacted] East European Division, Office of European Analysis and was requested by Harvey Shapiro, Deputy Director/Bureau of East-West Trade. Comments and questions are welcome and should be addressed to [redacted] Acting Chief, East European Division [redacted] 25X1

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o The USSR will have to continue providing substantial assistance if it wants to stave off economic decline in Poland.

Warsaw and its Western creditors may consider three options for dealing with the debt dilemma:

- o Poland's strategy is to rely on relatively fast economic growth to expand exports. We judge this to be infeasible because import requirements would grow faster than Polish projections and faster than both overall GNP and exports. The faster the overall economic growth rate, the lower the hard currency surplus.

- o Austerity, economic growth of about 1 percent per year, would yield a growing hard currency surplus as hard currency import requirements decline with constant exports. The austerity scenario could yield a $3.5 billion surplus by 1990 under favorable conditions while the rapid growth scenario based on Warsaw's Recovery Program would yield a $1.8 billion hard currency surplus.

- o Targeting new credits to specific export-generating projects, although a positive step, would not solve the debt problem because the number of potential projects is limited and the most marketable export products would likely have a high import content.

Warsaw is unlikely to adopt the reforms and austerity measures needed to address its debt problem as long as it perceives the the fruits of economic improvements will go only to foreign creditors -- whether in the West or the USSR -- and bypass both the Polish government and people. The Poles might take stronger actions to boost hard currency surpluses if a payments plan allowed Warsaw to keep some portion of the increased surplus. A simple payments plan that would serve both Warsaw's and the creditors' interests would include a rising annual base payment and a fixed share of any net hard currency earnings above the base payment. Creditors would receive some increase in cash flow without depriving the Poles of an incentive to improve trade performance. 25X1

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Scope Note

The analysis in this typescript is based on an econometric model [redacted] 25X1 25X1 25X1 POLGNP determines the resource costs and, thus, the feasibility of various levels of Polish economic performance -- with special attention to the ability of the economy to reduce its dependence on imports. The model is designed to project the effects of technological adjustments and structural shifts in the economy on requirements for the factors of production -- capital, labor, energy, and imports. The model can then measure the trade-offs between domestic production, soft currency imports, and hard currency imports. [redacted] 25X1 25X1

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Growing Out of the Debt Problem

Warsaw's strategy for dealing with its debt problem is to rely on relatively fast economic growth to expand exports. The blueprint for this strategy is contained in the "Program for Improving the State of Poland's Economy" that the Poles gave to Western creditor governments in 1984. The program projects annual increases in GNP of nearly 4 percent during 1986-90. It emphasizes growth in investment and exports but allows for a modest increase in per capita consumption as well. The key provisions of this program -- with growth rates scaled back -- have been incorporated into Poland's 1986-90 economic plan. 25X1

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Our analysis using the POLGNP econometric model indicates that Poland cannot grow out of its debt problems. In our view, Polish planners have underestimated popular pressures for increases in consumption, the amount of investment needed to modernize the capital stock, and the economy's need for energy and high-quality materials. The program rests on implausibly large gains in productivity of capital, labor, energy, and imports to enable the economy to boost output at the rates projected with comparatively small growth of inputs. 25X1

Our model indicates that moderately fast economic growth would require a much higher level of imports than Warsaw projects. Whereas the Recovery Program calls for hard currency imports to grow only 4.5 percent and for soft currency imports to increase by 3.5 percent annually to achieve the growth targets for 1986-90, we estimate these requirements to increase by 7.5 and 6.5 percent, respectively. Under the Recovery Program's growth targets, our model projects that:

- The hard currency trade surplus would increase from $1.1 billion in 1985 to only $1.8 billion by 1990, short of the Poles' goal of a $2.1 to 2.7 billion surplus. This would be insufficient to cover even interest payments on Poland's debt and restore at least minimum creditworthiness with the West.

- Poland's soft currency deficit would rise from approximately 650 million rubles in 1985 to 1.1 billion rubles by 1990. This would run counter to the goal of balanced soft currency trade by 1988 and a surplus by 1990 that was set in the Polish-Soviet trade protocol for 1986-90.

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Thus, we do not believe that rapid economic growth can generate the trade surpluses needed to deal with Poland's debt problem. The Poles will not be able to meet their growth targets unless Western creditors and the Soviets temper their demands for net resource flows from Poland. 25X1

Moderate Austerity

Our model's analysis indicates that with economic growth averaging 1 to 2 percent annually between now and 1990, the hard currency surplus could approach $3.5 billion by 1990 -- nearly double the $1.8 billion surplus of the faster growth scenario. * The improved trade balance results from a 6 to 7 percent annual reduction in hard currency import requirements under the austerity scenario compared to a 7.5 percent annual rate of increase with the growth scenario. This would be sufficient to halt the growth of the debt by covering interest payments but not enough for debt repayments. This seems the maximum amount of debt service payments Western creditors can hope for. From the Polish perspective, growth of 1 to 2 percent annually would prevent deterioration in the standard of living. 25X1

Creditor efforts to extract more payments through greater austerity would slow GNP growth below 1 percent but would add progressively less to the trade surplus because savings on imports would diminish. If creditors are willing to accept less, Polish growth could rise above 1 to 2 percent. The hard currency surplus would contract rapidly, however, because import needs would rise much faster than GNP. 25X1

The Soviets' Dilemma Under Austerity

Our research with the POLGNP model reveals a fundamental difference in the contribution of nonsocialist and socialist imports to the Polish economy. Whereas imports from the West are necessary for economic growth, imports from the Soviet Union and other socialist trading partners are essential for maintenance of the level of Polish GNP. With minimal growth in the Polish economy, imports from the West could drop 6 to 7 percent per year through import substitution. Socialist imports, on the other hand, would continue to inch up 1 to 2 percent per year.

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* This outcome rests on very favorable assumptions for Poland, including improvements in capital productivity beyond those expected given past performance, no labor unrest, no bad harvests, no problems in marketing exports, and no further deterioration in terms of trade.

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Despite the goals of the 1986-90 Polish-Soviet trade protocols that call for balanced Polish-Soviet trade by 1988, the USSR probably cannot stem -- much less reverse -- the net flow of resources to Poland without risking serious damage to the Polish economy. Furthermore, slow growth could even widen Warsaw's deficit with the USSR by limiting Poland's capacity to expand soft currency exports while soft currency import needs would continue to rise. Cutting back deliveries to Poland would not benefit the USSR because it would depress Polish export capacity and could well risk economic collapse. Even if Moscow can force the Poles to redirect some exports from the West to the USSR, the Soviets probably will continue putting more into Poland than they will get back. 25X1

Targeting Specific Export Possibilities

Some Western creditors have proposed targeting new credits to specific export-generating projects as a strategy for increasing Poland's debt repayment capacity. This approach, however, faces a number of obstacles:

- The number of potential projects is limited, so the strategy will not solve the overall debt problem.

- Products with the best prospects for sales in the West will themselves probably require a high level of hard currency imports in production, reducing the net hard currency earnings (see figure 1).

- Polish estimates of new credit requirements to produce exports probably omit indirect import content. Indirect import content concerns domestically produced inputs which themselves require imported inputs for their production. For example, the meat processing industry may use domestic livestock directly yet be indirectly dependent on imports if that livestock is fed imported feed and supplements. Including indirect inputs can double the imports required to generate a given product (see figure 2).

- Import requirements increase rapidly as rates of sector capacity utilization rise because high-cost import-dependent plants will be brought on line to meet the additional demand. Furthermore, straining the capacity of individual sectors will increase the need for new investment. Investment in plant and equipment, in turn has a very high import content (see appendix 1) Thus, efforts to generate exports will contribute the most to net hard currency earnings if the overall economy is growing very slowly.

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Figure 1
Import Content of Exports Assuming Healthy Economic Growth and High Capacity Utilization Rates

(Import Content Measured in Domestic Zlotys as Percent of Value of Exports in Domestic Zlotys)

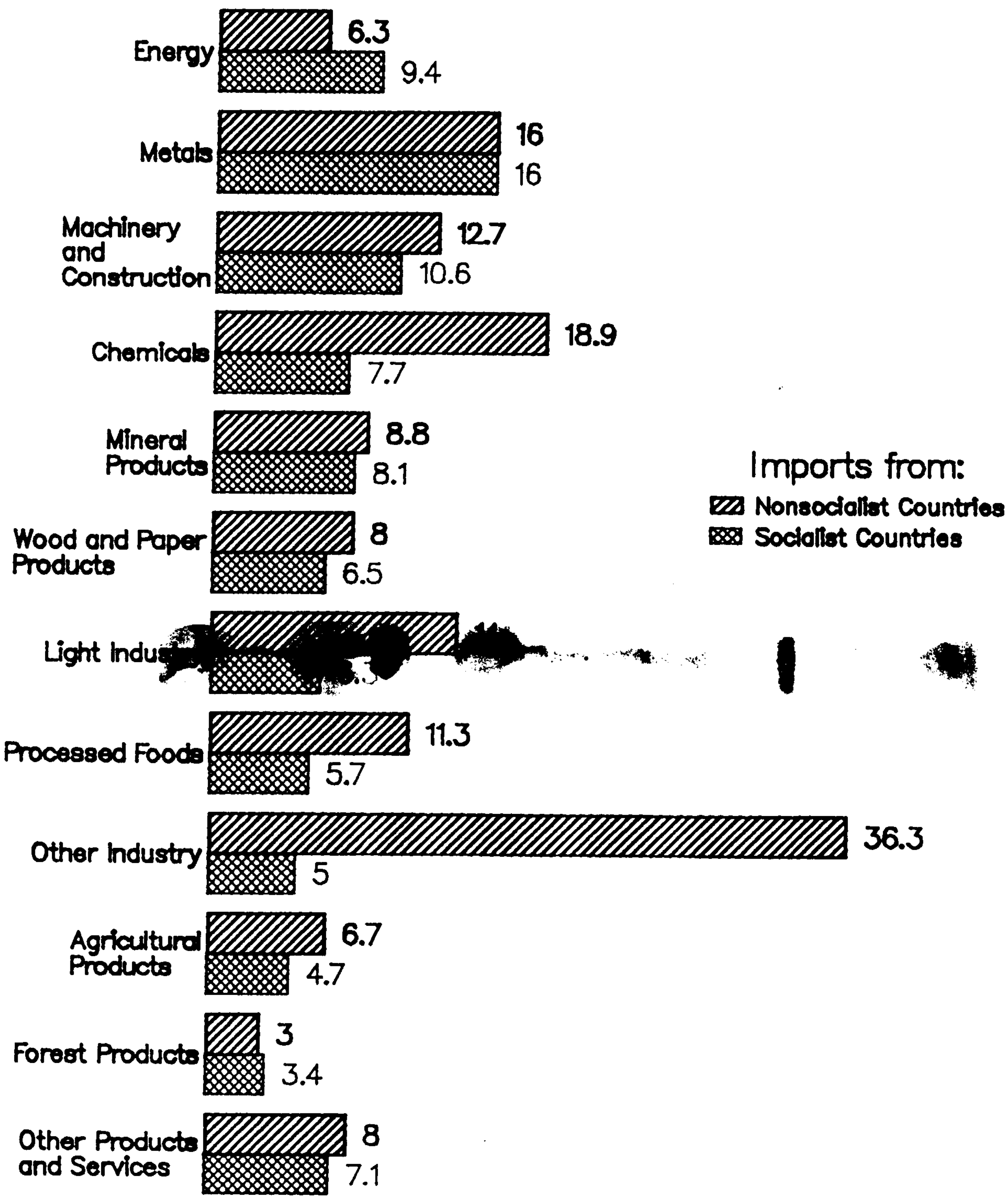

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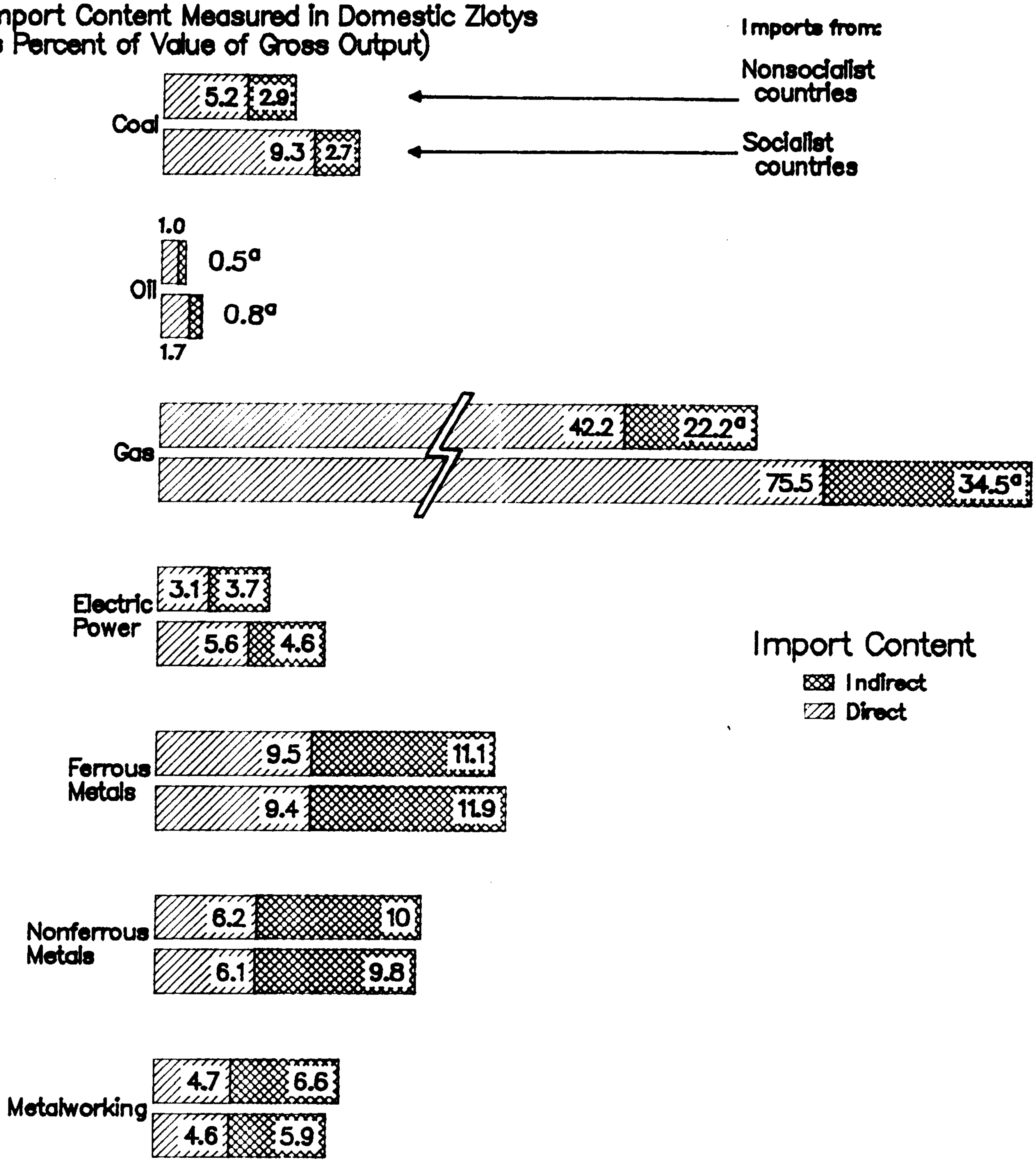
Figure 2

Import Content of Domestic Production by Sector Assuming Healthy Economic Growth and High Capacity Utilization Rates

(Import Content Measured in Domestic Zlotys as Percent of Value of Gross Output)



[a] Poland's tiny oil and gas production industry is very import-dependent. For these calculations the joint exploration, drilling, and production costs were attributed to oil and gas in proportion to the production of each. Since the wells have yielded mostly gas, gas bears most of the import costs in our calculations.

Figure 2

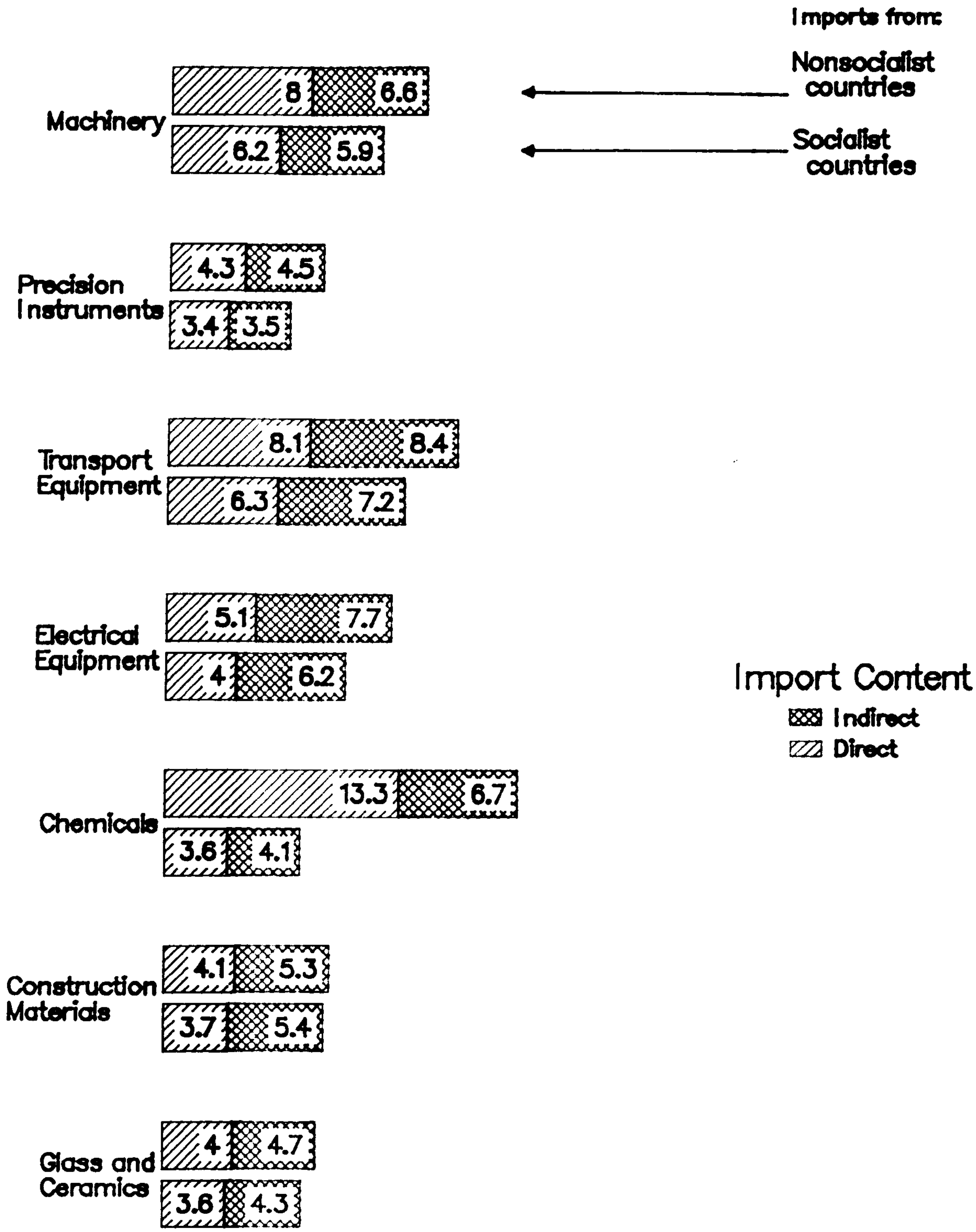

Imports from:
Nonsocialist countries
Socialist countries
Machinery
8
6.6
6.2
5.9
Precision Instruments
4.3
4.5
3.4
3.5
Transport Equipment
8.1
8.4
6.3
7.2
Electrical Equipment
5.1
7.7
4
6.2
Chemicals
13.3
6.7
3.6
4.1
Construction Materials
4.1
5.3
3.7
5.4
Glass and Ceramics
4
4.7
3.6
4.3
Import Content
Indirect
Direct

Figure 2

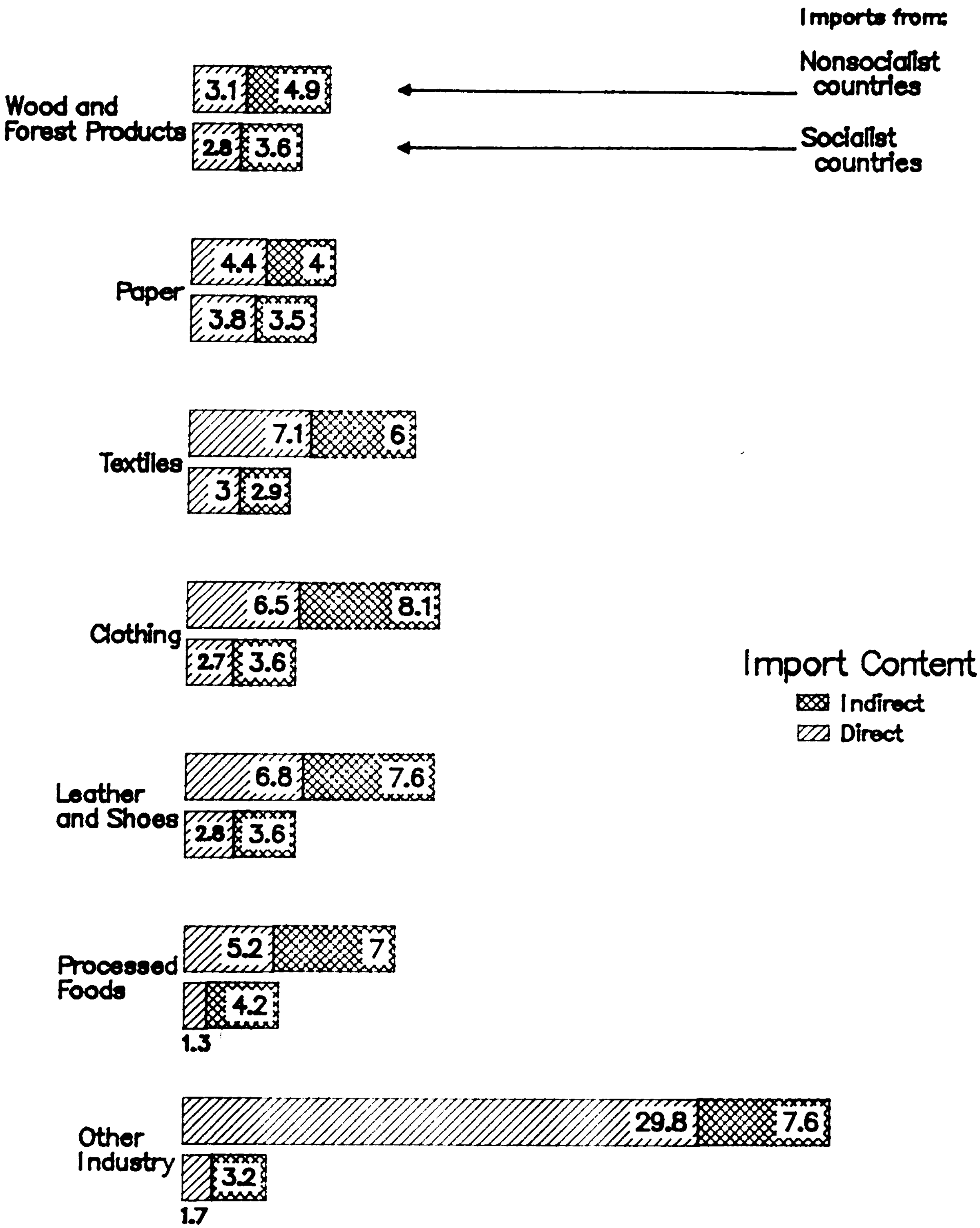

Imports from:
Nonsocialist countries
Socialist countries
Wood and Forest Products
3.1
4.9
2.8
3.6
Paper
4.4
4
3.8
3.5
Textiles
7.1
6
3
2.9
Clothing
6.5
8.1
2.7
3.6
Leather and Shoes
6.8
7.6
2.8
3.6
Processed Foods
5.2
7
1.3
4.2
Other Industry
29.8
7.6
1.7
3.2
Import Content
Indirect
Direct

Figure 2

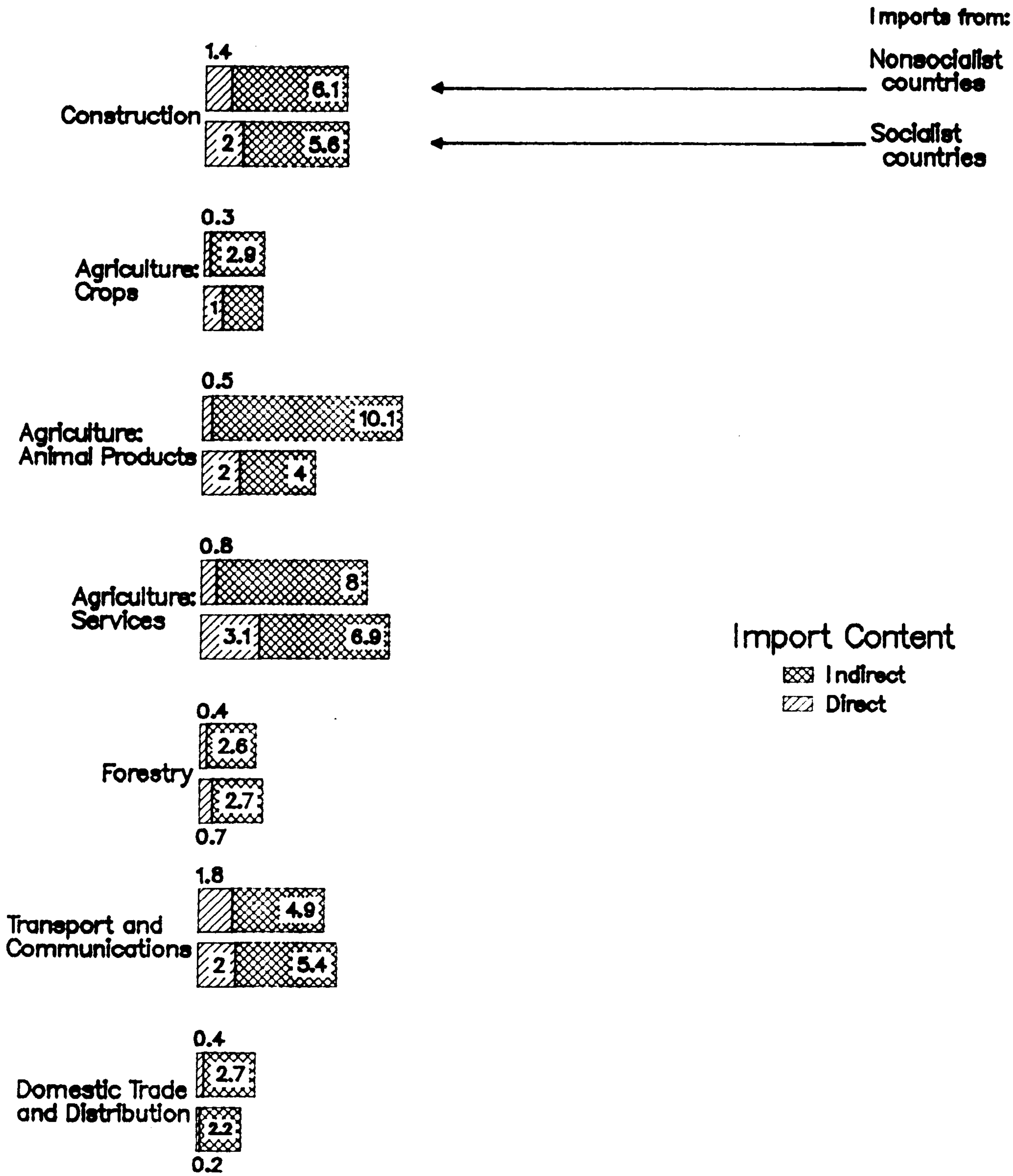
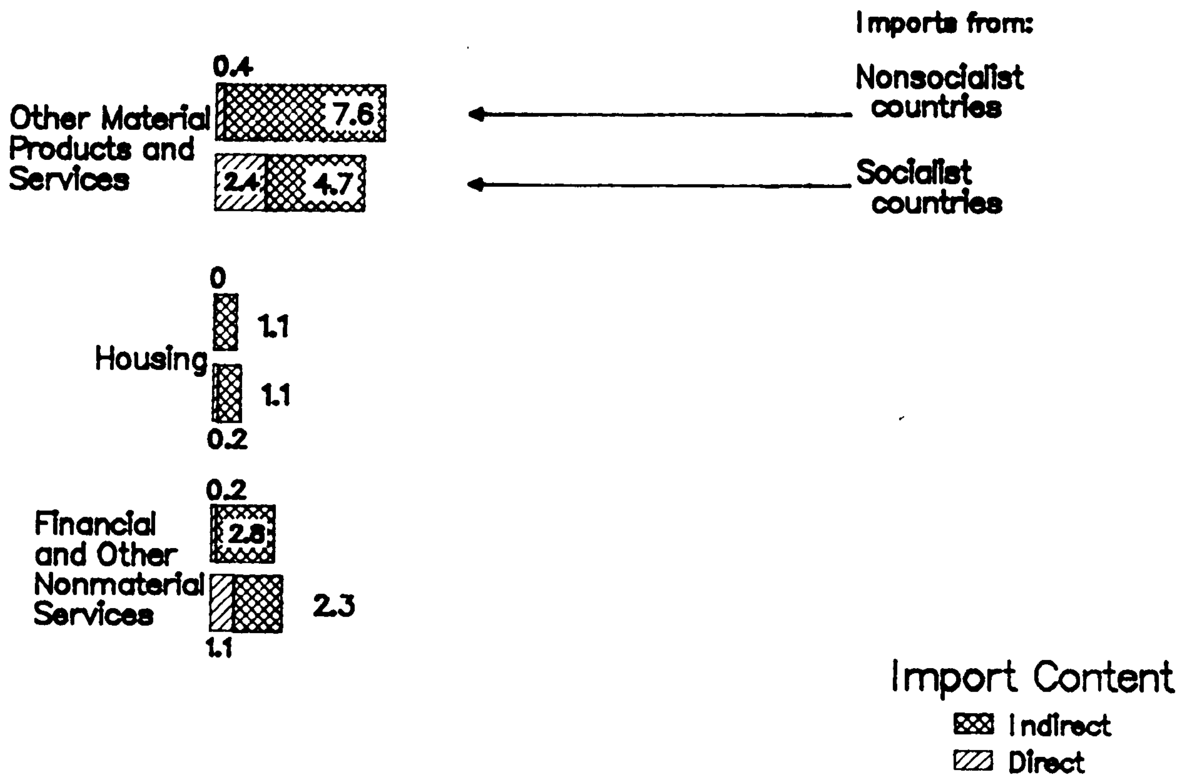

Imports from:
Nonsocialist countries
Socialist countries
Construction
1.4
6.1
2
5.6
Agriculture: Crops
0.3
2.9
1
Agriculture: Animal Products
0.5
10.1
2
4
Agriculture: Services
0.8
8
3.1
6.9
Forestry
0.4
2.6
2.7
0.7
Transport and Communications
1.8
4.9
2
5.4
Domestic Trade and Distribution
0.4
2.7
2.2
0.2
Import Content
Indirect
Direct

Figure 2


Imports from:
Nonsocialist countries
Socialist countries
Other Material Products and Services
0.4
7.6
2.4
4.7
Housing
0
1.1
1.1
0.2
Financial and Other Nonmaterial Services
0.2
2.8
2.3
1.1
Import Content
Indirect
Direct

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- o Exports with high hard currency import content are chemicals, metals, machinery, light industry, and processed foods. Yet machinery and processed foods, especially meat, are slated by the Poles for increased export over the next several years.

- o Import content also varies substantially within each category. For example, within processed foods, grain alcohol, wine, beer, and tobacco have very low import content. Sugar, fish, meat, and dairy products, on the other hand, have a very high import content. The high import content of "other industry" originates in processed animal fodder, feed, and supplements which require substantial imports. 25X1

<u>Extraction of Debt Payments from the Poles</u>

After the 1983-84 recovery of economic growth, Polish net hard currency earnings -- and hence debt servicing -- have been disappointing although still positive. The much touted reforms have done little to improve efficiency or reduce dependence on hard currency imports. Warsaw's apparent strategy is to delay facing the debt problem as long as possible, minimize current payments, and delay payment of arrearages until creditors have little choice but to grant new reschedulings (see appendix 2) The Poles may hope that new credits will eventually be made available or solution of other debtor countries' problems will provide a palatable precedent for solution of the Polish problem. 25X1

Warsaw is unlikely to adopt the reforms and austerity measures needed to address its debt problem as long as it perceives that the fruits of economic improvements will go only to foreign creditors -- whether in the West or the USSR -- and bypass both the Polish government and people. The Poles, however, might take stronger actions to boost hard currency earnings if creditors guaranteed Warsaw some portion of that increase. Such an incentive would require that terms be set according to the capacity of the economy to generate net hard currency earnings, rather than to the schedule of payments coming due. 25X1

A payments plan that would serve both Warsaw's and the creditors' interests would include a base payment that would rise each year and a fixed share of any net hard currency earnings above that needed to cover the base payment. For example, a base payment might be set at $1 billion in 1987, rising 10 percent every year thereafter. Warsaw would allocate to additional debt service, say, 25 percent of all net hard currency earnings

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exceeding the base payment while retaining the remainder. For this approach to serve Western creditor interests, Warsaw would also have to show that additional export capacity is not being used to reduce its ruble deficit. If Western creditors did not enforce such a condition, the gains from the extra hard currency resources that Warsaw is allowed to retain would accrue at least partially to the Soviet Union rather than to the Polish economy. [redacted] 25X1

Such an agreement could prove attractive to the Poles. First,it gives Warsaw a chance to retain at least part of any gains in net hard currency earnings. Second, it may help the Poles convince Moscow to maintain some net resource flow into Poland, since Warsaw could claim that it will retain much of that flow and not use it to support exports to repay Western creditors. [redacted] 25X1

Warsaw will, of course, negotiate to minimize both the base payment and the share of net hard currency earnings above the base paid to creditors. Creditor negotiators can trade off the two types of obligations -- a higher base payment in return for a lower share of the net surplus in excess of the base payment or vice versa. The base payment is a fixed obligation while the share portion is a bet on Poland's ability to improve its net hard currency earnings in the future. The potential trade-offs between fixed payment and share of net earnings provide a wide range of alternatives within which agreement might be reached -- much wider than if only a fixed payment or only a fixed share were considered. [redacted] 25X1

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Appendix 1: Import Content of Domestic Final Uses

Figure 3 indicates the degree to which Poland can adjust its import requirements by changing the mix of personal consumption, investment, and government spending -- even without undergoing any technological adjustments. Any shift of personal consumption expenditures away from food toward other consumption dramatically reduces imports from nonsocialist countries. The maximum effect comes from a shift toward housing where management, maintenance, and repair have virtually no direct import content and only miniscule indirect import content. (1) Housing, though, is considered "unproductive" in Marxist economic systems and is usually neglected; yet, it is one area where welfare can be enhanced and work incentives increased with almost no increase in imports. 25X1

A shift in personal consumption expenditures away from food and toward other (nonhousing) goods and services reduces the overall import content of the expenditures by nearly 16 percent. (2) 25X1
It also replaces nonsocialist imports with socialist imports.

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1 Housing here refers to the consumption of housing services and the current expenses for housing. It does not refer to the value or import content of housing construction, which is included in investment.
2 See Figure 3. The first set of bars shows the import content of personal consumption expenditures on food: 36.7 percent for imports from nonsocialist countries and 24.2 percent for imports from socialist countries for a total of 36.7 + 24.2 = 60.9 percent. The third set of bars, personal consumption expenditures on other things besides food and housing, indicates an import content of 13.9 percent for imports from nonsocialist countries and 37.5 percent for imports from socialist countries for a total import content of 51.4 percent. If 100 zlotys of personal consumption expenditures is shifted from food to other, the import content of that expenditure drops from 60.9 zlotys to 51.4 zlotys or by 9.5 zlotys. This reduction is 15.6 percent of 60.9 zlotys.

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Investment in Poland is highly import dependent. With virtually no limits on imports, almost half(3) of every investment zloty would go directly or indirectly for imports almost evenly split between socialist and nonsocialist imports. Reductions in investment result in immediate and substantial reductions in imports. [redacted] 25X1

Government activities are much less import intensive than other final uses with the exception of defense spending where procurement involves substantial imports from other socialist countries. [redacted] 25X1

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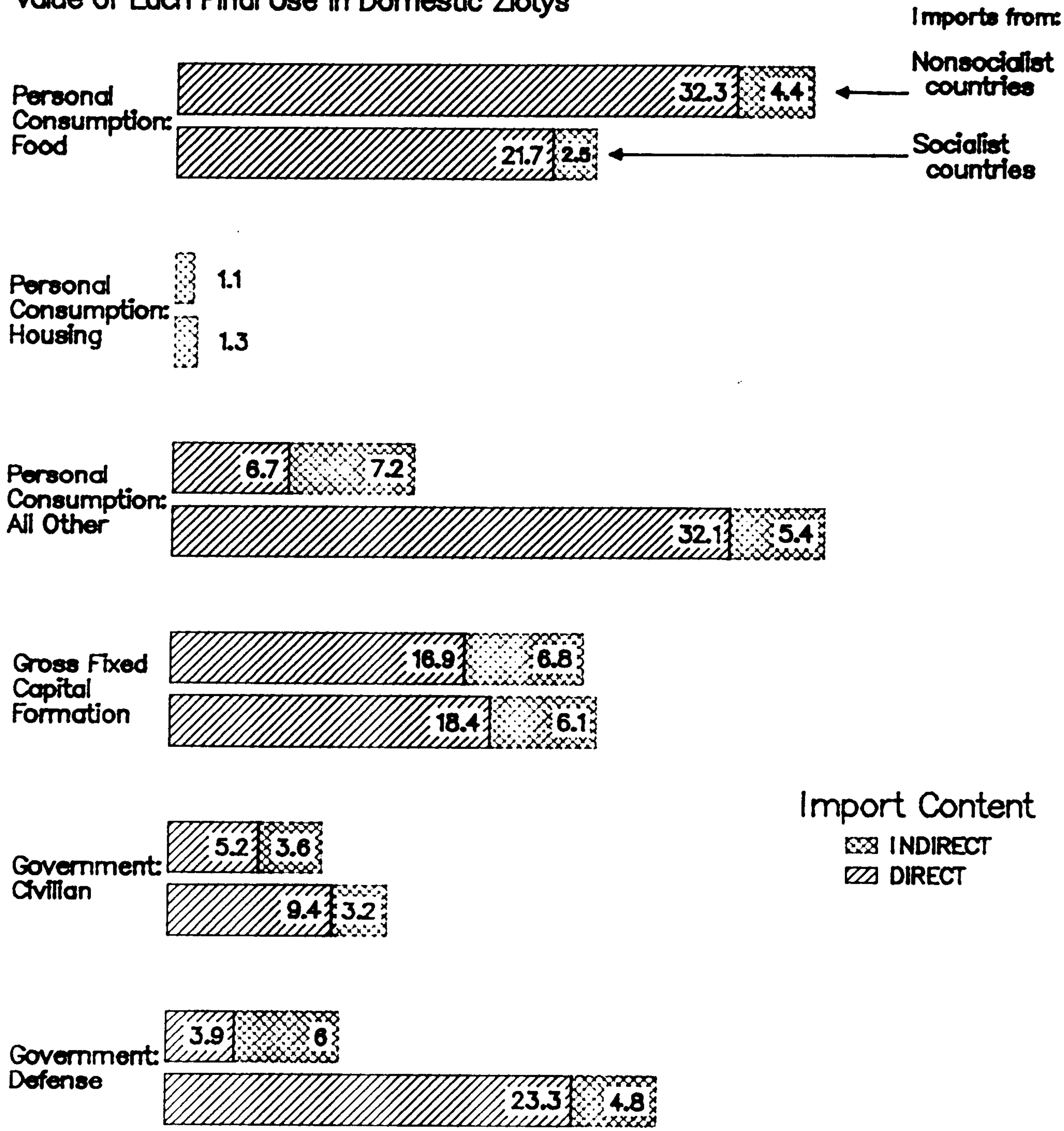
3 See Figure 3. The fourth set of bars indicates the import content of investment. Imports from nonsocialist countries comprise 23.7 percent of each investment zloty. Imports from socialist countries account for 24.5 percent. Adding the two numbers together yields a total investment content of 23.7 + 24.5 = 48.2 percent or nearly half.

[redacted] 25X1

Figure 3

Import Content of Domestic Final Uses Assuming Healthy Economic Growth, High Capacity Utilization Rates, and No Financial Constraints on Imports

(Import Content Measured in Domestic Zlotys as Percent of Value of Each Final Use in Domestic Zlotys



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Appendix 2: Current Economic Concerns

<u>Economic Growth</u> GNP grew 1.6 percent in 1985, down from 3.8 percent in 1984 and 4.9 percent in 1983...Indicates that recovery from 1980-81 crisis is stalling...slower growth likely to continue in 1986...foreign trade, construction, personal income growth cited as problem areas. 25X1

<u>1986-90 Plan</u> Calls for net material product to increase 3 to 3.5 percent per year through 1990, industrial production to increase 3 percent annually, agricultural production to increase 1.1 percent, consumption to increase by 2.2 to 2.9 percent...Capital spending set to increase 24 percent over 1981-85 total...Growth plans assume significant reduction of energy and raw material consumption...Stagnant coal production, rising energy demand may lead to energy shortages in the next few years...Aging capital stock will require higher investment rates and imports of investment goods than Warsaw can achieve. 25X1

<u>Living Standards</u> Food supplies have improved since 1981 with only meat and chocolate still rationed...Nominal incomes continue to rise faster than 18.2 percent annual measured inflation rate...Many consumer goods still in short supply indicating hidden inflation...Thriving underground economy cannot meet growing demands...Worsening environmental problems could lead to reduced public health and slower industrial development...Environmental issues could spawn increased demonstrations. 25X1

<u>Economic Reform</u> Leadership renewed calls for economic reform at Party Congress in June...Currently undertaking cadre review to oust reform opponents...Some high level personnel shifts have been made but bureaucratic and conservative resistance continues to limit reform implementation...Workers may distrust reforms as well, fearing unemployment, lower wages...Consumer austerity measures threaten to erode labor productivity, spark strikes or protests...Significant improvement of efficiency unlikely in near future. 25X1

<u>Trade Performance</u> Poland unlikely to meet projected hard currency trade surplus for 1986...Hard currency surplus narrowed to $430 million in first half of 1986 as exports declined 3 percent and imports increased 3.2 percent...Trade deficit with USSR continues to widen as imports surge by more than 10 percent...suggests Poles will be unable to balance trade with USSR by 1988. 25X1

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[redacted] 25X1

<u>Debt Policies</u> Warsaw claims commitment to repaying debts, but not at the expense of living standards...Signed 1986-87 rescheduling agreement with commercial creditors in September...1986 government agreement initialed in March...Poles cite higher growth, higher export growth rate as only solution to worsening debt problem...Warsaw claims it cannot meet obligations under current rescheduling agreements without new credits. [redacted] 25X1
[redacted] 25X1

<u>IMF</u> Poland was readmitted to the IMF in late May 1986...membership quota is 680 million SDR...Membership may improve commercial and government creditors' assessment of Polish creditworthiness. Poles unlikely to receive IMF credits until Article IV consultations and negotiation of economic adjustment program are completed, probably sometime in mid-1987. [redacted] 25X1

[redacted] 25X1

[redacted] 25X1

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