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Inflation Stabilization, Fiscal Deficits, and Public Debt Management in Poland[1]

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Poland edged toward hyperinflation in the latter half of 1989, but inflation fell dramatically after drastic reforms were enacted in January of 1990. We analyze the consistency between fiscal deficits and inflation targets, and we assess Poland's domestic and foreign debt management policies and the impact of the Brady debt reduction agreement on the relationship between fiscal deficits and inflation. We also assess the impact of financial sector measures on seigniorage revenue and the sustainability of the low inflation strategy. Such policies are shown to have a direct impact on the sustainability of inflation targets. *J. Comp. Econ.* June 2001, **29**(2). pp. 293–309. University of Amsterdam and CEPR, 1018 WB Amsterdam, The Netherlands; International Monetary Fund, Washington, DC 20431. © 2001 Academic Press

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1. INTRODUCTION

Poland threatened to slide into hyperinflation in the second half of 1989, but the hyperinflation process was stopped abruptly during the first quarter of 1990. The inflation rate has since been reduced to moderate levels. Inflation fell significantly

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from over 600% in 1989 to below 20% in 1996. This success has been sustained in later years.

Debt-management policies have played an important role in the macroeconomic stabilization package. The Polish debt rescheduling deal at the beginning of the 1990's decreased the foreign debt burden successfully and, together with the implementation of restrictive monetary policies, has removed the obstacles to achieving a sustainable fiscal balance. This process was supported by a substantial reduction in the noninterest fiscal deficit, mainly achieved through tax reform and the reduction of subsidies. All of this occurred while the links among monetary policy, exchange rates, and inflation were shifting due to a process of financial sector reform implemented concurrently with the stabilization package. Many of these issues are familiar from other countries, thus making an analysis of the Polish case of wider interest.

In order to analyze this experience, we outline a simple framework that links inflation, fiscal deficits, and public debt management and apply it to Poland. The framework is designed for environments that have sparse data and are undergoing structural change. It focuses on the interplay among interest rates, growth rates, and primary deficits in determining fiscal sustainability for different inflation targets. We pay special attention to the role of debt management and exchange rate policy and to the impact of financial sector reform on the relationships among asset demands, seigniorage, and inflation.

The framework draws on the public finance approach to inflation pioneered by Phelps (1973); his approach is also followed in the well-known analysis of the relationships among debt management, monetary policy, and inflation by Sargent and Wallace (1981). This paper extends their approach by incorporating a commercial banking sector, which is a crucial factor in understanding the links among fiscal policy, money growth, and inflation in many developing countries.

Section 2 describes the analytical framework, presents the calculation of the Polish real quasi-fiscal deficit for the consolidated government and central bank (CB) accounts, and gives a detailed empirical analysis of the revenue from seigniorage and its inflation dependence. Section 3 assesses consistency in 1992 and shows the impact of domestic and foreign debt management policies on the trade-off between inflation and fiscal deficits. In that section, we describe the Polish foreign debt reduction agreement and its impact on the inflation–fiscal deficits trade-off. The section also discusses other factors affecting the relation between fiscal deficits and inflation, such as real exchange rate changes, delays in fiscal adjustment, and changes in reserve requirements. Section 4 examines the situation in 1995 and 1996 in comparison to 1992, the year before the debt and financial market reforms took hold. Section 5 combines the results from the various sections and concludes that fiscal and financial policies in Poland, supported by two effective international debt renegotiations, have succeeded in providing a sustainable low inflation environment. The relative ease with which Poland seems to have weathered the Asia crisis in 1997 and the subsequent crash in Russia in mid-1998 supports that finding.