The Economic Situation in Poland

Jens Anton Kjærgaard Larsen, International Relations

INTRODUCTION

In 1989 Poland started the transition from planned to market economy via an extensive reform programme. The reforms led to a significant decline in production, albeit less pronounced and of shorter duration than in the other transition economies. In the following years the economic development was impressive, with sustained high growth, falling inflation and unemployment, and a rising standard of living. Over time the economy did, however, show signs of increasing imbalance, e.g. rising inflation and an increased current-account deficit. From the 2nd half of 2000 the economy rapidly lost momentum. Since then actual growth has fallen short of potential.

The first half of the article summarises the results achieved since the start of the transition and the prospects for bridging the income gap to the present EU member states. The second half discusses the current recession in the Polish economy, as well as the economic policy pursued.

FROM TRANSITION TO INTEGRATION

Up through the 1990s Poland's economy was very dynamic. After a brief, but deep, recession in 1989-91 in the wake of the transition from planned to market economy in 1989-90, the Polish economy began to expand again in 1992. The early start of the reform process, and a considerably higher growth rate than in comparable transition economies, cf. Chart 1, meant that Poland was the first transition economy where GDP in fixed prices reached the same level as immediately prior to the

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1 Poland's history from 1960 to 1989 was characterised by slow and hesitant reforms to remedy the deficiencies of the planned economy. If these limited reforms had any effect at all, they seem to have intensified the problems (Ebrill, Chopra et al, 1994). The Balcerowicz plan, which was officially implemented from 1/1-1990, was the first major breakaway from the planned economy. The plan included macroeconomic stabilisation to brake inflation, liberalisation of trade and prices, privatisation of state-owned enterprises and social compensation for exposed groups. Some of the reforms associated with the 1990 programme were, however, already introduced in 1989. For a brief description of the general elements of the transition process, see e.g. Kjærgaard and Larsen (2001).

2 With the exception of the Czech Republic, where the decline in production was smaller, but of longer duration than in Poland. There is a considerable body of literature to explain the general decline in production in connection with the transition. Experts still disagree as to why the decline was so significant and protracted. A discussion of this literature is beyond the scope of this article.
start of the transition. Poland reached this milestone in 1996. 5 years later, in 2001, the Polish economy was almost 30 per cent larger than in 1989. For comparison, GDP in fixed prices in a number of other Eastern European countries had not yet reached the pre-transition level by 2001.¹

This development has to some extent come as a surprise. In the 15 years leading up to the reforms Poland had not excelled in terms of growth, and the country had not experienced a similar period of sustained growth since the early 1970s.² Prior to the introduction of the reforms Poland was deemed to be in deep crisis with considerably greater challenges than its closest Eastern European neighbours (De Broeck and Koen, 2000). For instance, the monthly rate of price increases was 55 per cent in October 1989, and the government deficit in 1989 was approximately 7 per cent of GDP (Ebrill, Chopra et al, 1994). A number of factors may explain the favourable course of events. The consistent adherence to the reform programme is important. It was rapidly implemented, consistent and exten-

¹ However, the income levels in the planned economies were probably considerably overestimated, cf. Paldam (2002).
² Even though there are no consistent data series for GDP so far back in time, this view is supported by data for industrial output and the sectoral development (De Broeck og Koen, 2000).
sive, with a well-organised stabilisation policy and significant structural reforms, including speedy liberalisation of prices and trade. In addition, Poland's starting point was not all that poor. There was already a private sector of a certain size, accounting for approximately 30 per cent of the economy, at the onset of the reforms. Foreign creditors released Poland from a considerable part of its debt, and a legal system was in place which made it possible to enforce contracts. Combined with few barriers to setting up in business, this enabled the creation of a new, dynamic private sector that was not based solely on privatisation of state-owned enterprises.

In spite of the economic turnaround in 1992 and the subsequent progress, employment fell up to 1993 and has risen only moderately since then. Overemployment for political and social reasons, in the days of planned economy and up to 1990-91, in the range of 30 per cent of the workforce, is the likely explanation for the diverging development between GDP and employment. With significant growth in labour productivity, at approximately 4 per cent per year in the 1990s, there is – notwithstanding the economic progress – little reason to assume that the overemployment problem has been fully solved yet. As a result of the poor employment trend, the extensive reorganisation of trade and industry, and to some extent demographically conditioned growth in the labour force, unemployment has been high throughout the period, and must be said to include a considerable structural element. Even with the high growth in 1996-98 it was thus only briefly possible to reduce unemployment to below 10 per cent.

Investment activities expanded strongly during the 1990s, with a considerable foreign element, leading to the augmentation and modernisation of the capital stock. The increased capital deployment mainly took place within the formerly underdeveloped trade and service sectors, while investments in agriculture were more subdued. During the 13 years since the onset of the reforms Poland has seen strong structural development, cf. Table 1, with a significant decline in industry and agriculture's contributions to GDP. The sectoral structure, measured by GDP, has come to resemble that of the EU member states to a large extent, so the term "transition economy" has become somewhat misleading in this respect. The private sector accounts for around 70 per cent of GDP.

Geographically, Poland's growth has not been evenly distributed. Progress has mainly been concentrated in the Warsaw area and a small

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1 Legislation from 1934 relating to protection of private contracts and trade was reintroduced with few amendments.
number of large regions. However, the data available does not seem to suggest that the regional differences in growth have led to major regional migrations. Shortage of housing may have made people choose to commute rather than to move. An active social policy has helped to mitigate the effects of the reform policy and may also have contributed to limiting mobility. The distribution of income in Poland, measured as the Gini coefficient\(^1\), by and large remained unchanged (Koane and Prasad, 2000), \textit{inter alia} due to the emergence of a new middle class.

Owing to the economic policy, the structural reforms and the considerable productivity enhancements, it has over the years been possible to reduce inflation from being close to hyperinflation in 1990 to a level comparable with that of the EU.

Despite the high growth rates during the 1990s, the income gap to the present EU member states is still wide, as in most of the other applicant countries, cf. Table 2. Poland’s standard of living, measured as purchasing-power-adjusted GDP per capita, is thus still only approximately 40 per cent of the EU average. The main challenge to economic policy is thus to recreate sustained, robust and non-inflationary growth with a view to achieving a Western level of affluence. The wish for EU membership, and in due course adoption of the euro, can be seen as measures to meet this goal. After joining the EU, Spain, Portugal and above all Ireland, have seen

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\(^1\) The Gini coefficient expresses income disparity as a figure between 0 and 100. The lower the coefficient, the smaller the income disparity.
equivalent relative improvements in living standards over time. Bridging the income gap to the present EU member states is, however, a long-term project. Comparison of a projection of the trend growth in the EU member states with a projection of the growth estimates in the applicant countries' Pre-Accession Economic Programmes shows that it will take Poland more than 30 years to reach a standard of living equivalent to 75 per cent of the level in the present 15 EU member states. The level of the less wealthy EU member states, Greece and Portugal, may be reached sooner, but even so it will take many years for Poland to catch up.

Sustainable high growth will still require considerable investments, presumably significantly above the current level (UNECE, 2002). In this situation domestic savings are unlikely to serve as an adequate source of financing, so that foreign capital will still play an important, and presumably increasing, role. The development in the external debt may obstruct growth, particularly if the increasing external debt does not go hand in hand with enhanced export capacity. It is therefore important to seek to increase domestic savings. With a relatively stable level of private savings, continued reforms of government expenditure to limit government borrowing can hardly be avoided. EU membership could to some

### Table 2: CATCH-UP, 1996-2004

<table>
<thead>
<tr>
<th></th>
<th>Annual GDP growth rate</th>
<th>GDP per capita, euro, (as a percentage of EU-15)</th>
<th>GDP per capita (PPP, dollars)</th>
<th>Number of years to reach a level of 75 per cent of the average for 1996-2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland ...............</td>
<td>5.2</td>
<td>3.5</td>
<td>20</td>
<td>36</td>
</tr>
<tr>
<td>Bulgaria .............</td>
<td>-1.3</td>
<td>6.1</td>
<td>7</td>
<td>25</td>
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<td>Estonia ..............</td>
<td>5.1</td>
<td>5.8</td>
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<td>33</td>
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</tr>
<tr>
<td>Lithuania ...........</td>
<td>3.2</td>
<td>4.7</td>
<td>15</td>
<td>29</td>
</tr>
<tr>
<td>Romania ..............</td>
<td>-1.6</td>
<td>5.0</td>
<td>8</td>
<td>33</td>
</tr>
<tr>
<td>Slovakia .............</td>
<td>4.6</td>
<td>4.5</td>
<td>17</td>
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<tr>
<td>Slovenia .............</td>
<td>3.9</td>
<td>3.8</td>
<td>44</td>
<td>66</td>
</tr>
<tr>
<td>Czech Rep. ...........</td>
<td>0.9</td>
<td>3.8</td>
<td>24</td>
<td>65</td>
</tr>
<tr>
<td>Hungary ..............</td>
<td>4.0</td>
<td>5.3</td>
<td>22</td>
<td>47</td>
</tr>
<tr>
<td>Greece ...............</td>
<td>3.4</td>
<td>4.0</td>
<td>51</td>
<td>67</td>
</tr>
<tr>
<td>Portugal .............</td>
<td>3.8</td>
<td>1.8</td>
<td>51</td>
<td>71</td>
</tr>
</tbody>
</table>

Note: Projections for the applicant countries are based on the growth rates in the Pre-Accession Programmes (2001) up to 2004, after which constant growth at the 2004 level is assumed. For the EU member states, the European Commission’s projections, autumn 2001, are used up to 2003, after which the average growth rate in 1995-2003 is applied.

Source: The European Commission.

1 For Greece and Portugal growth and growth estimates for 2001-2003 are based on the European Commission’s economic forecasts, spring 2002.
2 The present 15 EU member states and the applicant countries, apart from Turkey.
extent lead to EU transfers, but membership would also give further pressure on spending in a number of areas, e.g. environmental investments, and would not bear the full brunt of the financing requirement.

Following Poland’s application for EU membership in 1994 the transition process became more focused, and the accession criteria the main objective of the ongoing reform process. The efforts to meet the requirements have borne fruit. In addition to the structural transformation described above, much progress has also been made in terms of integrating Poland’s economy with that of the West, cf. Table 3. Due to its size, however, the Polish economy is less open than that of the other applicant countries. The agricultural sector in Poland differs from those of the Czech Republic, Hungary and Slovakia in that it accounts for a very high share of employment. This indicates a need for further structural reforms. In its latest annual report on progress towards EU membership, from October 2002, the European Commission states that Poland, like 7 other transition economies\(^1\), will comply with the “Copenhagen criteria”\(^2\) upon accession in 2004. In addition to being a functioning market economy Poland is

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**STRUCTURAL INDICATORS** Table 3

<table>
<thead>
<tr>
<th></th>
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<th></th>
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</thead>
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<td>32.0</td>
<td>52.7</td>
<td>69.9</td>
<td>3.3</td>
<td>18.8</td>
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<td>58.5</td>
<td>...</td>
<td>51.2</td>
<td>14.5</td>
<td>...</td>
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<tr>
<td>Estonia</td>
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<td>95.4</td>
<td>...</td>
<td>76.5</td>
<td>6.3</td>
<td>7.4</td>
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<tr>
<td>Latvia</td>
<td>54.5</td>
<td>45.8</td>
<td>...</td>
<td>67.6</td>
<td>4.5</td>
<td>13.5</td>
</tr>
<tr>
<td>Lithuania</td>
<td>51.9</td>
<td>45.5</td>
<td>...</td>
<td>47.9</td>
<td>7.6</td>
<td>19.4</td>
</tr>
<tr>
<td>Romania</td>
<td>39.9</td>
<td>34.1</td>
<td>...</td>
<td>63.8</td>
<td>12.6</td>
<td>42.8</td>
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<td>Slovakia</td>
<td>76.0</td>
<td>73.5</td>
<td>40.8</td>
<td>59.1</td>
<td>4.5</td>
<td>6.5</td>
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<tr>
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<td>59.1</td>
<td>64.8</td>
<td>63.8</td>
<td>3.2</td>
<td>9.9</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>75.2</td>
<td>71.4</td>
<td>38.4</td>
<td>68.6</td>
<td>3.9</td>
<td>5.1</td>
</tr>
<tr>
<td>Hungary</td>
<td>66.7</td>
<td>62.5</td>
<td>42.1</td>
<td>75.1</td>
<td>4.1</td>
<td>6.5</td>
</tr>
</tbody>
</table>

Source: UNECE (2002).

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1. The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Slovakia and Slovenia. In addition, Cyprus and Malta already comply with the Copenhagen criteria.

2. The Copenhagen criteria are the overall requirements for EU membership. The criteria were adopted by EU heads of state and government at the European Council in Copenhagen in 1993. The criteria set out a number of political and economic requirements for EU membership, and furthermore the countries in question must have implemented and be able to enforce the EU’s **acquis communautaire**. The political criteria comprise democracy, the rule of law, human rights and respect for minorities. The main economic requirement is for the countries to be well-functioning market economies with the capacity to withstand competitive pressure and market forces within the EU. This requires e.g. well-functioning financial sectors, liberalised trade and pricing, and macroeconomic stability.
assessed to be able to handle the competition pressure and market forces in the EU if the reform programme currently tabled is implemented.

STAGNATION SINCE 2000

As a result of a major slowdown in growth since mid-2000, cf. Chart 2, cracks have begun to appear in the picture of a dynamic Polish economy. This development is not attributable to one single factor, but rather to interaction between a number of internal and external economic factors.

In the wake of Russia's economic crises from August 1998 and declining growth in the EU member states, Poland experience a marked\(^1\), but brief, decline in economic growth from the 2nd half of 1998. Employment began to fall, while unemployment rose. This dampening was countered by the economic policy. While fiscal policy remained more or less unchanged, Narodowy Bank Polski eased its monetary policy significantly from April 1998 to January 1999, in view of falling inflation. The reference interest rate was lowered by 11 per cent to 13 per cent in this period. The considerable monetary-policy stimulation\(^2\), combined with increasing confidence and an economic upswing among European trading partners, led to considerable growth from the beginning of 1999. However, growing imbalances such as accelerating inflation and increasing current-account deficits also ensued. Inflation rose from just over 6 per cent in mid-1999 to more than 10 per cent during the following year. The current-account deficit increased from almost 4.5 per cent of GDP in 1998 to just over 8 per cent of GDP in 1999. To offset the increasing imbalances Narodowy Bank Polski raised the leading interest rate several times. From a level of 13 per cent in October 1999 it had been raised to 19 per cent by September 2000. Real interest rates reached more than 10 per cent, a level sustained until the end of 2001. From the beginning of 2000 domestic demand diminished accordingly via lower investments. Private consumption also weakened, but to a lesser degree. As domestic demand was weak the full effects of the international slowdown were felt, and growth in GDP in fixed prices fell to 1.1 per cent in 2001. The weak growth continued into 2002, but without leading to actual recession. The economic slowdown has affected the labour market. From a level below 10 per cent before the Russian crisis, unemployment has climbed to just over 17 per cent in 2002, the highest level in any OECD country. The other economic imbalances have

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\(^1\) For Poland the loss of the export markets in the former Soviet Union after Russia’s economic crisis is estimated at around 3 per cent of GDP.

\(^2\) The direct interest-rate effect on investments, is, however, presumably relatively weak in Poland, where approximately 60 per cent of business investments are financed via current revenues (UNECE, 2002).
been reduced, however. The current-account deficit has almost halved since 1999, and inflation also fell significantly up to the autumn of 2002.

The current low Polish growth stands in contrast to the growth in the other EU applicant countries with comparable structures and external influence. Many commentators have pointed to the lack of interaction between monetary and fiscal policy, with tight monetary policy and very expansionary fiscal policy as a key reason for the slowdown. While actual government deficits declined up to 2000, the cyclically adjusted deficits remained generally unchanged, in the last few years exceeding the actual deficits, cf. Chart 3.

The significant slowdown in 2001, combined with a number of discretionary measures, caused the budgetary position to deteriorate by 3 percentage points to a deficit of 5 per cent of GDP in 2001. According to the OECD (2002) more than half of this budgetary deterioration is attributable to cyclical factors, including lower government revenues as a con-
sequence of more subdued growth. The other half is especially a result of discretionary fiscal-policy measures, including extraordinary pension disbursements of almost 1 per cent of GDP as compensation for inflation in previous years. Added to this is the effect on government finances of recent years’ ambitious structural reforms, among these a pension reform, a municipal reform and reforms in health and education. The effects of the reforms have apparently not initially received sufficient analysis, and so their budgetary effect has surprised (UNCE 2001). In 2002 and 2003 the deficit is expected to stabilise at the high 2001 level. The large structural deficit makes it questionable whether government finances are sustainable in the long term. The OECD expects the government debt burden to be approximately 47 per cent of GDP by the end of 2002¹.

In view of the high government deficit, and despite the negative experience with the activist policy pursued since 1998, the political focus has been on the opportunities for monetary policy to initiate renewed growth in the light of the current low inflation. On several occasions the government has thus indicated that depreciation of the Polish zloty was desirable, either through intervention in the currency market

¹ Under the Polish constitution the public debt must not exceed 60 per cent of GDP.
or by lowering interest rates. This would also stimulate domestic demand.

Since February 2001 Narodowy Bank Polski has repeatedly lowered the rate of interest by so far 12.0 per cent to 7.0 per cent in October 2002, cf. Chart 4. The lower interest rates reflect the declining inflation, in line with the monetary-policy objective, cf. Box 1. The real interest rate, measured as the reference interest rate adjusted for actual inflation, is still relatively high, despite the downward tendency since 2000. Narodowy Bank Polski has stated that a precondition for a sustained lower level of interest rates is continued reforms, including reforms of government expenditure. Fiscal consolidation would also contribute to reducing the appreciation pressure on the Polish zloty seen up to 2001.
THE MONETARY-POLICY FRAMEWORK

Box 1

Since September 1998 Narodowy Bank Polski has pursued a monetary policy based on an inflation target. This was originally as part of a crawling-peg exchange-rate system, but from April 2000 with a floating exchange rate. The overall objective of monetary policy is to ensure price stability. The medium-term objective is, as stated in Medium-term Monetary Policy Strategy for the Years 1999-2003, to bring inflation below 4 per cent at the end of 2003. The medium-term objective will be updated in the 2nd half of 2002. The objective is supplemented by annual Monetary Policy Guidelines containing the short-term objectives for the following year. In recent years Narodowy Bank Polski has published this short-term objective as a 2-percentage-point band around a central inflation target. For 2002 the original inflation target was 5 per cent ±1 per cent. In view of the favourable development in inflation, including food and energy prices, the target was adjusted to 3 per cent ±1 per cent in June 2002. This is also the target for 2003.

The inflation target has not always been met. While inflation in 1998 was below target, it exceeded the upper limit of the inflation band in 1999 and 2000, cf. the chart below. In 2001 inflation was again below the target band at year-end, and the development in 2002 pointed in the same direction until the target was adjusted. According to the OECD (2002) a number of specific circumstances can impede monetary policy based on an inflation target in transition economies. Firstly, publicly regulated prices play a significant role in the consumer price index. Secondly, the transition economies are typically small open economies, making them vulnerable to external price shocks. Finally, the post-transition period has been brief, and experience with an economy dominated by market forces is still limited. This makes it more difficult to predict price development than in more mature market economies.

INFLATION AND INFLATION TARGETS

Chart

Per cent

<table>
<thead>
<tr>
<th>Year</th>
<th>Inflation</th>
<th>Upper limit</th>
<th>Lower limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999</td>
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<td></td>
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<td>2001</td>
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<td></td>
</tr>
<tr>
<td>2002</td>
<td></td>
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</tbody>
</table>
While lower interest rates are likely to weaken the Polish zloty further, the need for this is not an absolutely clear-cut case. The zloty has depreciated by more than 10 per cent vis-à-vis the euro since the early summer, cf. Chart 5, and the development in Polish goods exports in current prices is still positive, indicating that Polish exporters are still competitive.

Finally, the effect of lower interest rates on real-economic activity can be assumed to be both delayed and uncertain, given the relatively underdeveloped financial sector, cf. Table 4.

**POLAND’S ROAD TO THE EURO**

While Poland can be presumed to be close to EU membership, its adoption of the euro lies further into the future. Poland will, however, like the other applicant countries that become member states, be obliged to introduce the euro when the criteria of the EU Treaty are deemed to have been met, and the country receives political approval. In October 2002 the Polish authorities indicated a wish to adopt the euro as soon as possible after joining the EU. The government and Narodowy Bank Polski intend to pursue an economic policy that will ensure that Poland meets the nominal convergence criteria in 2005. The economic policy should, however, also take account of the eco-

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1 See Kjærgaard and Sørensen (2001) for a detailed discussion of the applicant countries and the euro. On 8 October 2002 the Polish ministry of finance and the central bank presented the result of a committee’s work on Poland’s integration into EMU. The press release can be found on the home page of the Polish central bank (http://www.nbp.pl).

2 The Maastricht Treaty states a number of economic requirements for countries that would like full EMU participation. The rate of inflation may not exceed 1.5 per cent of the average inflation in the three EU member states with the lowest rate of inflation; the long-term interest rate must not be more than 2 percentage points above the interest-rate level in the three EU member states with the lowest inflation; the government budget deficit must, as a main rule, not exceed 3 per cent of GDP; and the debt must, as a main rule, not exceed 60 per cent of GDP. In addition, the country must have been a member of the Exchange-Rate Mechanism, ERM II, for two years prior to adoption.
nomic development and generally support the economy's return to high, balanced growth in order to ensure real convergence. As the convergence criteria are worded, Poland, on joining the EU from 2004, can introduce the euro in 2006 at the earliest.

Rapid adoption of the euro may involve a number of problems. The euro's introduction will require the exchange rate upon accession to be determined quickly. In countries such as Poland that face a long period of significant growth, there may be a long-term tendency for the real effective exchange rate to appreciate.\(^1\) Real appreciation is actually seen for Poland, cf. Chart 6. Sustained real appreciation may involve a potential conflict between the requirement for low inflation on the one hand, and maintaining the central rate in ERM II on the other. However, the problem is not likely to be urgent in connection with membership of ERM II for a short period. In connection with Greece's observance of the convergence criteria the problems of an appreciating currency were

\(^1\) The real effective exchange rate states the domestic price level in relation to the price levels of trading partners in the same currency. An appreciation of the real effective exchange rate means that inflation is higher than abroad and/or that the nominal exchange rate is appreciating. This argument is known as the Balassa-Samuelson hypothesis. The reasoning is that the real exchange rates of the transition countries will appreciate as a consequence of higher productivity increases in the traded-goods sectors than in the non-traded-goods sectors vis-à-vis abroad. Via wage formation, this presses the price of non-traded goods, and thus the general price level, upwards. The Balassa-Samuelson effect is an equilibrium phenomenon and not a consequence of macroeconomic imbalances or an inexpedient economic policy. Estimates of the Balassa-Samuelson effect vary depending on the period and countries, but a range of 1-3 percentage points of inflation seems plausible according to Deutsche Bundesbank (2001). The hypothesis is, however, somewhat controversial.
solved by revaluing the central rate in ERM II. This was not contrary to the convergence criteria.

The introduction of the single currency will make the requirements for price and wage flexibility even more relevant, so it is important that Poland continues, and speeds up, the ongoing structural reforms. In its latest assessment of Poland the European Commission calls for the completion of restructuring and privatisation measures. Further reforms are especially required within heavy industry, the financial sector, energy and agriculture. This will also help to improve government finances. The European Commission recommends a consolidation of government expenditures to give scope to ease the tax burden, limit the government deficit and leave room for higher government investments. The fiscal consolidation will also be necessary to meet the convergence criteria, and to create a basis for the fiscal policy to play its key role as a cyclically stabilising instrument.
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