Speedy Reforms Pays Off, but Social Costs Must Be Considered

In their article "Reform Boosts Growth and Foreign Investment" (*Transition*, June 1997), Marcelo Selowsky and Ricardo Martin make a convincing case in favor of "good policies": sound policy reforms boost economic growth and foreign direct investment. Even the immediate negative impact of liberalization policies on output—for example, in the Baltic and CIS states—does not, in their view, "change the general proposition that fast stabilization, liberalization, and privatization bring benefits earlier."

My findings (reported in the table), based on in-depth studies of twelve reforming economies (China, the Czech Republic, Estonia, Hungary, India, Kazakhstan, Latvia, Lithuania, Poland, Russia, Uzbekistan, and Viet Nam), provide similar encouraging results. (These findings

Reform Speed and Transition Record: 1991-95

Speed of reform	*GDP growth in 1995*	*Unemployment rate in 1995*	*Inflation*			*Foreign exchange regime in 1995*	*Trade policy regime in 1995*	*Foreign investor perception by end-1995*	*FDI as share in gross fixed investment in latest year*
			Rate in 1995	*Decline over reform period*	*Decline from peak to next year*				
I. High speed									
1. Poland	3	9	5	4	4	7	4	6	8
2. Estonia	4	6	3	1	1	2	2	2	2
3. Latvia	9	3	4	2	3	3	3	5	3
4. Lithuania	7	4	7	3	7	4	6	8	7
5. Czech R.	6	1	1	8	5	1	1	4	6
6. Viet Nam	2	-	2	5	6	6	10	7	4
II. Medium speed									
7. Hungary	8	7	6	10	10	9	5	3	1
8. India	5	-	-	-	-	8	7	11	10
9. China	1	-	-	-	-	5	11	1	5
III. Low speed									
10. Russia	10	5	9	7	9	11	9	9	9[c]
11. Kazakhstan	12	8	8	6	2	10	8	10	11[c]
12. Uzbekistan	11	2	10	9	12	12	12	12	12[c]
Correlation coefficient with reform speed ranking	0.48 (12) 0.66[a] (11 without China); 0.87[a] (9, without Asia)	-0.25 (9, without Asia)	0.62[b] (10, without India and China)	0.75[a] (10, without India and China)	0.5 (10, without India and China	0.74[a] (12)	0.78[a] (12)	0.52[b] (12)	0.58[a] (12)
Correlation coefficient with 1995 foreign exchange regime ranking							0.69[a] (12)	0.66[a] (12)	0.61[a] (12)
Correlation coefficient with 1995 trade policy regime ranking								0.46 (12)	0.48 (12)
Correlation coefficient with (end-1995) foreign investor perception ranking									0.85[a] (12)

Note: The correlation coefficients are the pairwise Spearman rank correlation coefficient estimates. The sample size is stated in parentheses under each estimate.

a. These estimates are statistically significant at the 5 percent level.

b. These estimates are statistically significant at the 10 percent level.

c. These rankings are not based on any calculations. I have assumed that the Russian share of FDI in gross fixed investment in 1995 was higher than that in India, Kazakshtan, and Uzbekistan, in that order.

Rank 1 is assigned to the country with the highest 1995 GDP growth rate and FDI share in gross fixed investment (in the latest year), the most liberal 1995 foreign exchange and trade policy regimes, and the most positive foreign investor perception by end-1995. Rank 1 is assigned to the country with the lowest 1995 unemployment and inflation rates, and the sharpest decline of the inflation rate during the period and from its peak to next year.

The decline in the inflation rate for each country over the reform period is calculated as the proportionate difference between the highest inflation rate and the 1995 inflation rate. Inflation rate decline from peak to next year is measured as the proportionate drop between the highest and next year's inflation rates.

China, Viet Nam, and India are omitted from the sample in estimating the correlation between reform speed ranking and 1995 unemployment rate ranking because the unemployment problem in these Asian economies is not comparable with that in the remaining countries. The former is essentially structural, whereas the latter resulted from macroeconomic stabilization and privatization measures.

India and China are omitted from the sample in estimating the correlation coefficient between reform speed ranking and the three inflation rate rankings because these two economies were not marked by the extreme initial inflation rates prevailing in the remaining countries. Viet Nam's inflation rate in 1988 was 400 percent.

Source: Data are available from Padma Desai's introduction in Going Global: Transition from Plan to Market in the World Economy (MIT Press, 1997).

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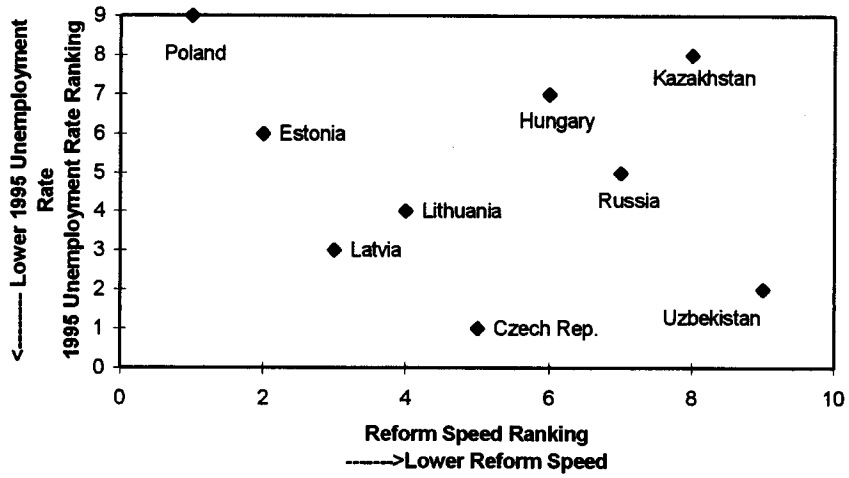
are discussed at length in my introduction in the forthcoming volume, "Going Global: Transition from Plan to Market in the World Economy," to be published by the MIT Press.)

The estimates generally support the conclusions reached by Selowsky and Martin:

- The correlation coefficient between reform speed and 1995 GDP growth rate is 0.87 if the three Asian economies (which did not experience an output decline) are omitted.
- The coefficient between reform speed and inflation decline is 0.75 if China and India (which did not experience high inflation) are omitted. On the other hand, links of reform speed with the 1995 inflation rate (with a coefficient of 0.52), and with the decline of inflation rate from its peak to the next year in a single swoop, are rather weak (0.50).
- Correlations between reform speed and foreign exchange regime, trade regime, FDI environment, as well as FDI share in gross fixed investment, range from 0.52 to 0.74. It is reasonable to conclude that speed pays off in terms of increased globalization.
- Globalization has also proceeded in lockstep: an exchange rate regime, marked by a convertible currency in place, evidently plays a role in enhancing foreign investors' positive view and actual response, that is, increased investments. (The coefficients are 0.66 and 0.61.) The exercise also suggests a link between the foreign exchange and trade regimes in 1995 (0.69).
- Speedy reform and lower unemployment rates do not go together: the correlation coefficient between reform speed and the 1995 unemployment rate is -0.25, although statistically not significant. (The three Asian economies, where defining and measuring unemployment presents problems, are omitted.) Speed is good for growth turnaround but may result in higher unemployment (see figure). The correlation coefficient between the GDP growth rate and the unemployment rate for Estonia, Latvia, Lithuania, and Poland, the celebrated cases of shock therapy, is negative, at -1. Such a trade-off implies that though speedy reforms may produce good outcomes such as growth and globalization, they may come at the cost of short-term unemployment. Further, rising unemployment may itself endanger the sustainability of reforms by provoking a political reaction.
- The choice of speedier reforms is desirable in those economies where, in the pursuit of successful transition, the risk is judged to be unimportant, and the short-term costs are deemed to be socially acceptable.

Figure. Country Ranking According to Reform Speed and 1995 Unemployment Rates



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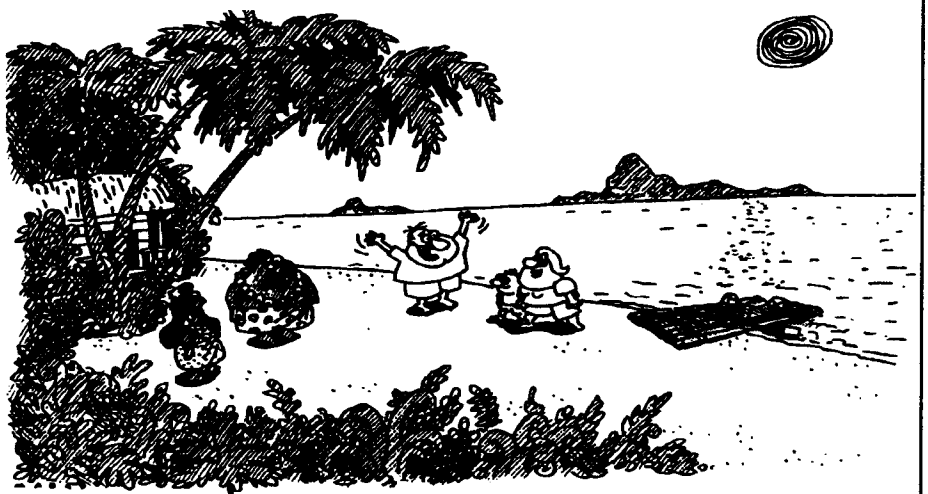
Happy People



"We found paradise on earth. They say they have no idea who is the island's finance minister."

From the Hungarian magazine *Hócipö* .

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