CHAPTER 15

Patterns of Reform

THE CONTOURS OF THE WORLD ECONOMY have changed radically over the past few years as a whole series of countries have embarked upon dramatic transformations. Almost every region of the world has been affected: Latin America and the Middle East, in response to the debt crisis and oil price shocks; China and Viet Nam, as they undertake market reforms; Sub-Saharan Africa, as the continent struggles to restore growth; and Central and Eastern Europe and the former Soviet Union, as they make their epic transition to a market system.

Most of these transformations involve a shift from a failed development strategy to a new one. They often occur in a context of crisis: in response to external shocks, as in Latin America after the debt crisis and in Sub-Saharan Africa following the slump in commodity prices, or to a general collapse of the previous system, as in the former centrally planned economies. But international shocks often simply bring the problems of failed growth into the open and expose the internal inconsistencies of the system in place.

Whatever the cause, the collapse of a development strategy forces countries to undergo reform. Some countries, like the Democratic People's Republic of Korea, resist and try to stay with the old strategy as long as possible. Others, such as Nigeria and Venezuela, get stuck for a time between strategies. But more and more countries, from Poland to Chile, are taking the need for change head-on, rapidly adjusting to new realities and switching to new development paths. This switch typically involves turmoil and potentially high adjustment costs but, if successful, leads the economy onto a path of faster growth.

The wide variety of causes of change and the different starting points of countries facing similar shocks make it difficult to generalize about their impact on workers and the appropriate policy response. But the experience of the past decade makes clear that workers suffer more when necessary reforms are delayed or aborted, that restoring sustained growth is the key to a successful transformation, and that there is an important role for government policy in easing the transition for workers and equipping them to succeed in new circumstances.

This chapter maps out a taxonomy of economic transformations and highlights the implications of each type for the labor market. It then focuses on how differing initial conditions affect the overall reform strategy and the role of macroeconomic policy.

Major features of reform

No one country's experience in managing transformation is exactly like another's. But each involves some combination of macroeconomic stabilization, liberalization of trade and internal markets, and institutional reform. The last two are part and parcel of the strategic shift to greater international integration and a reduced role of the state. All three have an impact on labor. We distinguish four broad patterns that transformation takes in different countries; Table 15.1 summarizes how these patterns differ on each of the three dimensions of reform:

- *The industrial postsocialist pattern.* Typical of the industrial former centrally planned economies, these transitions are characterized by radical institutional reform, huge drops in GDP, and substantial redeployment of labor across sectors and from the state to the private sector. Nearly 195 million workers in these economies are struggling with transition.
- *The Latin American pattern.* These transformations combine stabilization and substantial liberalization, especially of trade. They are associated with moderate rede-

Patterns of reform are distinguished by their differences in emphasis.

Table 15.1 Characteristics of the four major patterns of reform

	Scope of reform		
Pattern	**Stabilization**	**Liberalization**	**Institutional reform**
Industrial postsocialist	Major	Major	Major
Latin American	Moderate to major	Moderate	Moderate
Sub-Saharan African	Minor to moderate	Moderate to major	Moderate
Asian agrarian	Minor	Moderate to major	Moderate to major

In reforming economies in Latin America and Africa, real wages often fell sharply and then recovered, while unemployment often remained moderate.

Table 15.2 Real wages and unemployment in four reforming countries in Latin America and Sub-Saharan Africa

Country	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Real wages (index)[a]													
Bolivia	196.4	200.0	181.8	145.5	101.8	76.4	65.5	100.0	61.8	76.4	..	..	..
Chile	82.0	94.3	100.9	105.6	116.1	97.3	100.0	94.2	94.5	93.9	99.3	104.0	105.2
Mexico	..	..	129.4	135.5	133.5	93.6	100.0	94.4	66.5	66.2	81.2	93.7	103.3
Ghana	275.6	226.8	243.9	143.9	129.3	100.0	146.3	212.2	218.8	254.3	254.3	295.7	379.3
Unemployment rate (percent)													
Bolivia	..	..	7.5	6.2	7.5	8.2	6.6	5.7	4.2	5.9	11.5	10.7	..
Chile	14.0	14.0	10.0	11.0	20.0	15.0	14.0	12.0	9.0	8.0	6.0	5.0	6.0
Mexico	..	..	4.7	4.2	4.2	6.1	5.6	4.4	4.3	3.9	3.5	2.9	2.8
Ghana	..	..	..	..	..	0.5	0.4	0.5	0.5	1.8	1.2	..	..

.. Not available.
a. The index is set equal to 100 in the initial year of adjustment.
Source: World Bank staff estimates,

ployment of labor and some decline in GDP. This pattern is consistent with the experiences of most Latin American countries, but also of some economies in the Middle East and North Africa, and that of the Philippines. About 155 million workers in those regions are affected.

- *The Sub-Saharan African pattern.* Macroeconomic decline typically precedes reform in these adjustment episodes, which are characterized by profound restructuring within a small modern sector and by a relatively weak rural supply response (due to weak infrastructure and continuing policy biases). There are approximately 70 million workers in Sub-Saharan African countries struggling with adjustment.
- *The Asian agrarian pattern.* These transitions in primarily agricultural economies are marked by steady growth in GDP, some institutional reform, and (over time) potentially a large redeployment of labor. This is the pattern in China, India, and Viet Nam. Slightly over a billion workers, well over a third of the world's work force, live in the Asian agrarian economies.

The impact of reform on the labor market

The labor market plays an important role in determining the success of adjustment and reform and their impact on living standards. The response of real wages to economy-wide drops in the demand for labor, and the ease with which labor can be redeployed from collapsing sectors, together have a large impact on the welfare of the working population during transitions. Different patterns of employment losses, real wage declines, and unemployment increases have very different implications for the distribution of income and the welfare of the population.

Real wages and unemployment

Most adjustment involves a fall in the aggregate demand for labor as a result of macroeconomic decline and institutional reform. Adjusting to this fall in labor demand usually requires a decline in the real wage. Many countries that went through severe macroeconomic adjustment in Latin America and Sub-Saharan Africa experienced dramatic fluctuations in real wages, which at their lowest fell to 30 percent of their peak levels—a far greater decline than that of GDP (Table 15.2). Real wages fell because nominal wage increases typically lagged behind inflation. In all successful adjustment episodes, however, wages recovered as macroeconomic adjustment curbed inflation, but sometimes not to their former levels. This pattern is visible in Bolivia, Ghana, and Mexico, among others. Large real wage declines usually reduced the need for absolute falls in employment, and unemployment in these countries remained moderate throughout—with Bolivia a possible exception. In a few Latin American and Sub-Saharan African countries, real wage fluctuations were less extreme; an example is Chile, where wage declines were moderated by institutional mechanisms such as the indexation of wages to prices, but at the cost of much higher unemployment.

Patterns of wage and employment adjustment among former centrally planned countries fit into two distinct groups. China and Viet Nam, which weathered the transition to the market without macroeconomic decline, showed fairly steady growth in real wages and negligible unemployment. Industrial postsocialist economies such as Latvia, Poland, and Russia, on the other hand, all suffered a combination of sharp drops in real wages and falls in employment (Table 15.3). In Poland wage declines were less severe and the rise in unemployment was sharper, whereas in Russia real wages fell by more, but open unemployment has remained low. These differences reflect both the influence of institutional factors, such as the level of unemployment benefits, and choices by firms and workers about labor shedding versus reductions in hours worked per employee.

Relative wages and the redeployment of labor

All transformations involve the reallocation of labor from unviable jobs to higher productivity sectors and activities. What matters here is not the aggregate response of wage levels, but whether the labor market can send the signals that attract labor to those markets where demand is high. The labor market performs this task primarily though changes in relative wages, with wages in expanding sectors rising relative to those in contracting ones. A temporary increase in wage differentials encourages labor to flow out of unviable jobs into new jobs in the growing sectors. The faster the flow of labor to the growing sectors, the faster the desired adjustment in national output. If that flow is sluggish—because relative wages are not changing, because adjustment costs are high, or because old jobs become unviable before new ones are created—the economy may experience larger transitory declines in employment and parallel rises in unemployment.

Two indicators of the impact on labor are the aggregate change in the openness of the economy (for centrally planned economies, in the openness to trade with market economies) and the rise in the share of private employment. For developing countries already oriented to markets, the increase in openness appears more important; for some industrial postsocialist countries, both shifts can be very large (Figure 15.1).

Most reforming economies show significant shifts in relative wages. In Ghana relative wages increased in both agriculture and mining, the two sectors favored by the reform program. In Mexico intersectoral wage differentials were compressed initially but later widened, with wages in growing, export-oriented industries such as transport equipment rising relative to those in contracting, import-substituting sectors. In Chile manufacturing wages rose relative to the average wage, and within manufacturing, wage differentials across sectors and by skill level also increased. Sizable changes in relative wages are also evident among the industrial postsocialist countries. Sectoral wage dispersion in the Czech and Slovak republics has risen, and a similar increase in the variance of wages across industries has occurred in Bulgaria.

Employment usually shifts in parallel to these movements in relative wages. Bolivia, Côte d'Ivoire, and Ghana all experienced shifts back into agriculture as a result of movements in relative prices and wages. In Costa Rica employment moved into industries producing exportable goods. And in the Czech and Slovak republics, Poland, and

Economies in transition show a variety of labor market adjustment patterns.

Table 15.3 Real wages and unemployment in five former centrally planned economies

Economy	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Real wages (index)[a]										
China[b]	82.7	94.9	100.0	108.2	109.1	108.3	103.1	112.6	117.2	..
Hungary	..	..	..	..	99.3	100.0	98.7	96.6	97.9	96.8
Latvia	..	..	..	..	90.3	94.9	100.0	73.9	49.6	54.7
Poland	..	..	..	81.4	93.6	100.0	75.7	75.5	73.4	71.2
Russia	..	..	..	..	90.0	95.3	103.5	100.0	70.0	73.4
Unemployment rate (percent)										
China	1.9	1.8	2.0	2.0	2.0	2.6	2.5	3.0	..	..
Hungary	..	..	..	..	0.3	0.4	1.9	7.8	13.2	12.6
Latvia	..	..	..	..	0.0	0.0	0.0	0.1	2.3	5.7
Poland	..	..	..	0.1	0.1	0.1	6.3	11.8	13.6	15.7
Russia	..	..	..	..	0.0	0.0	0.0	0.1	4.8	5.5

.. Not available.
a. The index is set equal to 100 in the initial year of adjustment.
b. In 1986 the first major attempts to reform the state enterprise sector were made.
Source: World Bank staff estimates.

Increases in the openness of the economy and in private employment matter.

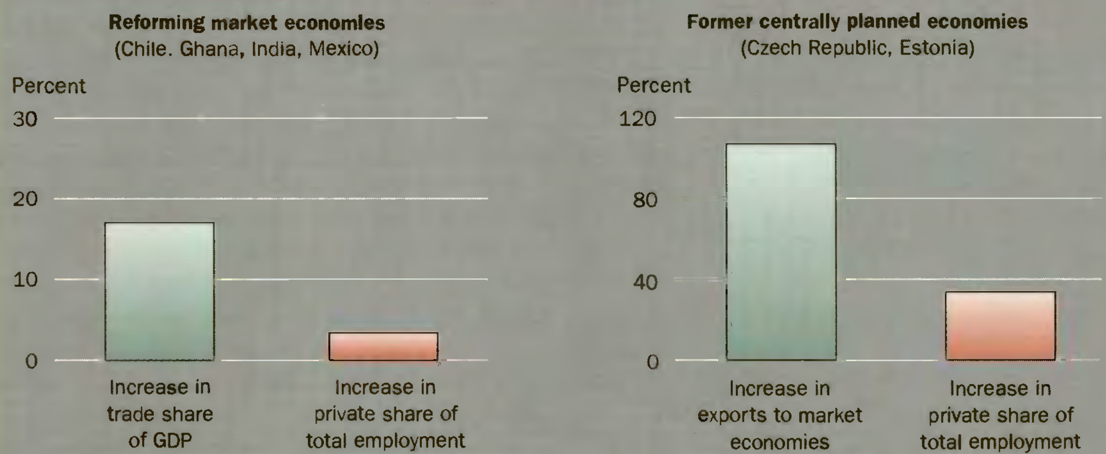

Figure 15.1 Increases in trade and in private employment in selected reforming economies. Data are for 1975-93 except for Mexico (1980-93), Czech Republic (1990-93), and Estonia (1989-93). The trade share is exports plus imports divided by GDP. Source: World Bank staff estimates.

Russia, labor flowed from industry to services, and from the public to the private sector. In Russia, for example, the share of state employment declined from nearly 83 percent in 1990 to 67 percent in 1993.

The constraints imposed by initial conditions

Initial conditions are an important influence on the scope and pace of reform. The pace of job destruction, for example, can be managed only if the formerly protected sector is small relative to the rest of the economy. Similarly, a gradualist approach to reform is easier in an economy that starts from macroeconomic equilibrium than in one plagued by high inflation or shortages of foreign exchange. A comparison of China and Russia illustrates this. China chose a two-track approach to reform: it continued state control of existing enterprises while permitting growth of a new, nonstate sector largely outside government control. This strategy was possible because the inefficient state sector accounted for a relatively small share of the economy. And because China had a far larger informal agricultural sector than more heavily industrialized Russia (Figure 15.2), it had experienced less misallocation of resources.

These different initial conditions constrained both the path of transition and the strategic choices open to policymakers. China's large rural supply potential gave a powerful initial spurt to growth and employment creation in the nonstate sector and allowed the government to take a gradualist approach to reform of inefficient state enterprises. Lacking such supply potential, the countries of Central and Eastern Europe and the former Soviet Union had to reform their state sectors and accept the destruction of state employment rather than postpone reforms as China did. As a general proposition, initial conditions are more advantageous when labor and capital are highly mobile, and where there are viable sectors with a strong potential for increasing supply. Countries with a developed formal private sector and only moderate protection required less sectoral reallocation of labor than did the former centrally planned economies. In contrast, massive labor reallocation is required in the countries of Central and Eastern Europe and the former Soviet Union. Many Sub-Saharan African countries had little misallocated labor but experienced weak short-run output responses because of inadequate infrastructure and institutional support and continued policy biases against agriculture.

The role of policy

The choice and sequencing of policies can also have a big impact on the speed of transition and the welfare of workers. The key policy concern in managing structural reform is how to facilitate the flow of workers from unviable jobs to new ones without raising the short-term costs of adjustment. Policy choices involve several dimensions.

The first policy choice is *when to start adjustment.* There is sometimes room for discretion: Peru could have initiated reform in the mid-1980s but chose to delay—at great cost

China's informal agricultural sector, many times the size of Russia's, may have helped China in its transition.

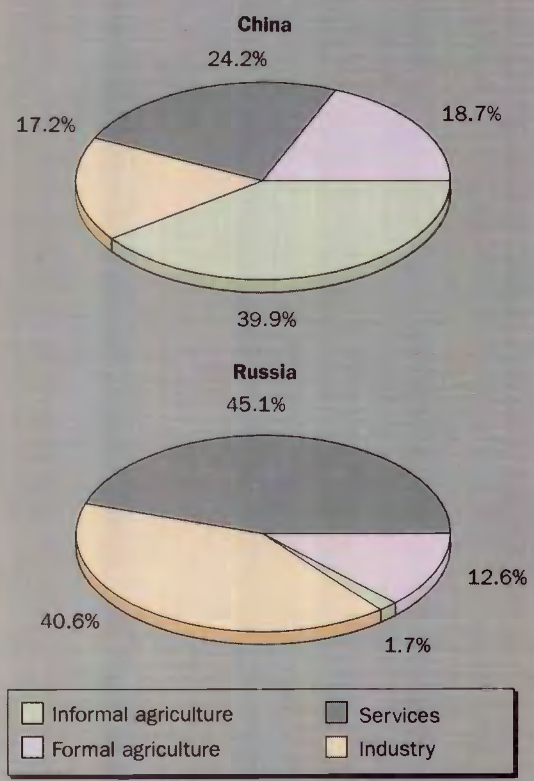

Figure 15.2 Sectoral distribution of employment in China and Russia. Data are for 1992. "Formal" here refers primarily to collectivized agriculture, "informal" to family farms. Source: World Bank staff estimates.

in terms of increasing poverty. But it is generally better to tackle reform as soon as trust in the government's commitment has been established. If policymakers wait until the economy collapses, they will have fewer options and probably a more painful transition. Tackling reform before the government has established its commitment and credibility, however, can backfire and set back the cause of reform, with disastrous consequences for growth, as is evident from the experience of Côte d'Ivoire in the 1980s.

Second, policymakers have to decide the *speed of reform*. Should reform be gradual, with slow destruction of unviable jobs? Or should it be rapid, even at the risk of encouraging a sharp initial fall in aggregate employment? From labor's perspective the ideal is to phase out jobs only as new jobs are created, and thus to minimize the drop in total labor demand. This strategy has been used by such countries as China and India, which have chosen to protect unviable jobs to avoid social and political difficulties, even though the inefficiency of the protected sector will at some point have to be addressed. For most countries, however, a gradualist approach is rarely an option. Most economies begin reform in the midst of a macroeconomic crisis, with accelerating inflation and an unsustainable current account deficit. Tackling stabilization and liberalization simultaneously is then the only option. Rapid stabilization can only work if the government's stated intention to be tough on inflation is believed. Most often this calls for rapid disinflation to establish credibility, precluding a gradualist approach. The more aggressive and comprehensive the reform package, the more credible the government's intentions, and the sharper the change in people's expectations and behavior.

The third dimension of policy design concerns the *sequencing of reforms*. An important lesson of both failed and successful reform attempts in Sub-Saharan Africa and Latin America is that governments must take into account the interdependence of markets in the transition process and their different speeds of adjustment. Reform must not stop with goods and capital markets, especially because labor market adjustment is almost always slower than that of goods and capital markets anyway. Labor market reform is often the missing ingredient that can hamper the process, as a sluggish labor market response leaves the partially reformed economy vulnerable to shocks during the transition. The collapse of the Chilean program in 1982 illustrates this point. By 1980 Chile had liberalized both its external and its financial markets, but it had only partially reformed the labor market and had left wage indexation mechanisms intact. A sudden increase in capital inflows during 1979–81 led to an overappreciation of the peso, compounded by the indexation of wages to past inflation. The peso appreciated further in real terms. In 1982 the currency collapsed, depreciating by nearly 90 percent in just a year; output contracted by 14 percent; and the unemployment rate increased to a quarter of the work force.

The *level of the real exchange rate* is the fourth crucial element of policy design, and one that Chile's 1982 experience highlights. Large real overvaluations of a country's currency can have significant adverse effects on tradable-goods industries and can weaken the response of exports and the creation of new jobs. Ultimately, real overvaluation of the currency can undermine the whole reform process. Côte d'Ivoire in the mid-1980s attempted to liberalize while sustaining a fixed exchange rate and a large fiscal deficit: the result was real appreciation of the currency, an enlarged import bill, and a balance of payments crisis. Failed adjustment translated into stagnant growth and declining GDP per capita for most of the decade. In contrast, Ghana's liberalization was accompanied by several large devaluations of the cedi and by an adjustment in macroeconomic policies so as to reduce inflation. The result was a real devaluation, which provided a major impetus for the growth of exports and cushioned the impact of reduced protection on the import-competing sector.

A fifth dimension of policy design concerns the *political economy of reform.* Experience shows that the key to successful adjustment is a credible commitment to moving away from an old, bad development path to a new, growth-friendly equilibrium. Governments must gain this credibility, not simply by repeating the mantras of the International Monetary Fund and the World Bank, but by following a consistent approach to reform.

A credible and sustainable reform program requires that government, capital, and labor perceive a common interest. Winning the support of organized labor is critical, especially if, as is sometimes the case, unions represent only that part of the labor force that was relatively privileged before the transition and may have a vested interest in impeding reform. Making the long-term gains from reform explicit can help build support for change, as can mechanisms that precommit the government to follow through with the reforms and prevent it from reneging on its promises. In Israel and Mexico during the 1980s, all-encompassing social pacts helped gain broad support for reform. Such pacts may also play an important role in South Africa in the 1990s. Social pacts can provide a vehicle for labor, employers, and governments to reach some consensus on the reform package as a whole and on the tradeoffs involved. They can also help break nominal price-wage inertia. But social pacts have important drawbacks. In particular, there is a conflict between the coordinated wage adjustments that social pacts bring and the strong need for relative wage flexibility and labor reallocation during restructuring. To resolve this conflict, countries that have centralized union bargaining may want to move quickly to a decentralized arrangement once they achieve stabilization. In early 1995 Mexico moved in that direction—perhaps belatedly—by terminating centralized wage agreements in favor of decentralized bargaining.

• • •

Over the past two decades many developing and former centrally planned countries have undertaken major shifts in their development strategies. Two features have dominated these shifts: a move toward export-oriented policies and open markets, and a reassessment of the role of the state. These long-term changes pose unique challenges to the functioning of labor markets. They require an acceleration of the redeployment of labor from unviable sectors to expanding ones. And they involve coping with sharp, transitory drops in the demand for labor nationwide. How labor fares during these periods of major change depends on how successfully countries manage these two tasks. Although initial conditions matter greatly in easing the adjustment process, so do policy choices about the timing, pace, and sequencing of reform.

CHAPTER 16

Winners and Losers

WORKERS SUFFER DURING THE wrenching transition from a failed development strategy, even if in the long run they benefit from the change. The poor may find it especially difficult to cope with the falls in wages and employment that tend to occur during the transition. Sometimes women are disproportionately affected. And the pain can be deeply felt if the transition is accompanied by recession or if the renewal of growth takes longer than expected.

Are the burdens that stabilization and reform programs place on workers an inevitable cost, or are they evidence of the programs' flawed design? Many observers—from union spokespersons to some international and nongovernmental organizations—argue that, in developing market economies and former centrally planned economies alike, structural adjustment policies are too preoccupied with inflation and fiscal balance, and with deregulating and liberalizing markets, and too little concerned about the immediate impact on workers. A review of the evidence certainly suggests