

# **PERSPECTIVES ON THE SEQUENCING AND SPEED OF ECONOMIC REFORM IN ETHIOPIA**

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## **1. INTRODUCTION**

There is a small but now rapidly growing literature on the speed and sequencing of economic reforms. The topic was little discussed until recently. However, the slow pace of recovery of developing countries and events in Eastern Europe under the auspices of the Bretton Woods institutions have made it increasingly relevant.

Despite the recent rise of interest in sequencing, however, there is no consensus within the economics profession on just what sorts of reforms are desirable, let alone in what order. Initial conditions influence the policies that should be followed, and obviously differ among different economies (contrast Eastern Europe and sub-Saharan Africa, two disparate regions in which economic reform is clearly on the agenda). Though sequencing is influenced by conditions which are specific to a country, it is clear that some reforms must come before or occur in tandem with others.

The order and speed of economic reform has also received further focus with the beginning of economic reform in Eastern Europe which entails system transformation in contrast to policy reforms within a given system as in most developing countries. As a result, sequencing of economic reform has become just as important as articulating appropriate economic policies.

The main objectives of this paper is to provide some perspectives on phasing and speed of economic reform in Ethiopia. Section 2 of the paper assesses the issues of phasing and speed of reforms as well as country experiences with this in the background. Section 3 discusses the challenges of phasing and speed of reforms in Ethiopia, and provides a proposal on sequencing the country's economic reform program.

## **2. ISSUE OF SEQUENCING AND SPEED**

### **2.1 The Sequencing Problem**

Economic reform is necessitated by the existence of severe imbalances and distortions. Ideally, 'first best' solutions would require simultaneous removal of all distortions. But in real life this is not possible. Some policy measures have to precede others to provide early signals. If so, does the order and speed of reform matter? The answer is surely it does matter. If it matters, is there an optimal sequencing of reforms?

There are costs associated with adjustments particularly in the short term. The choice of shock or gradualism becomes, then, which of the two approaches achieves the objectives of economic adjustment at a lesser cost.

Shock policies can be exclusively oriented toward stabilization, e.g. rapid imposition of austerity and/or a price freeze as anti-inflation moves. Alternatively, "global" shocks aim at attaining stabilization and massive restructuring at one go. The Polish package of 1989-90 is the best known recent attempt at global shock therapy.

The speed problem is more than an economic consideration. It is also concerned with the political feasibility of the reform. Because of the cost (unemployment, bankruptcies, etc.), opposition to the reform may form, thus endangering the process. Gradualism has implication for the credibility of the reform. The public might take gradual reform as indecision, as if it may not be implemented. The public may thus take steps that will undermine the effectiveness of the reform program.

Economic reason suggests slower pace of reform measures. Most authors support gradualism on the speed of policy measures in economic reform programs.

There has been intensive debate on several points regarding phasing and speed of reform (Gelb and Grag, 1991). The following are some of the questions raised in the debate:

- a) Should price reform come before or after enterprise reform ?

Those who argue that price reform should come before enterprise reform point out that enterprise reform and privatization will not succeed because prices do not reflect true costs (hence markets cannot judge efficiency) and also it is not possible to impose "hard budget" constraint on public enterprises before introducing market prices.

On the other hand, those who argue that price reform should come after enterprise reform indicate that freeing prices in the presence of monopolies will simply be translated into higher prices and profits without improving efficiency. Obviously this is not desirable and competitive environment should be created before price liberalization.

- b) Should trade liberalization come early and fast or later and slower?

The proponents of early trade liberalization argue that it exposes the domestic economy to the world price structure and thereby increases competition.

The proponents of late and slower trade liberalization, on the other hand, stress the negative consequence that the economy has to endure from the shocks generated by early trade liberalization.

- c) Should large-scale privatization be "quick and dirty" or slower and more careful?

Faster rate of privatization is seen to raise efficiency quickly, speed restructuring, create new forces that support further reforms, while weakening traditional power centers whose interests are bound to be threatened by the reform.

Slower rate of privatization, on the other hand, has beneficial effect in allowing the careful handling of its impact on government finance, employment and income distribution. Hence, restructuring should precede privatization and firms should not be given away rather hastily.

- d) Must full-scale financial sector reform go hand-in-hand with enterprise reform or can it come earlier?

Financial sector reform (banks, interest rate, etc.) is closely related to enterprise reform because banks have accumulated bad debts emanating from enterprise losses. Therefore enterprise reform and bank portfolio restructuring are best done hand-in-hand.

Those who argue for early action in the financial sector point out that it is only autonomous financial institutions and liberalized financial markets that can play the critical role of allocating capital as enterprises are restructured.

Since many countries have implemented economic adjustment measures, what are the lessons from their experiences? Sure enough actual outcomes have been influenced/determined by concrete economic and political conditions in each country.

Empirical studies have not produced hard and fast rules that should be followed, rather showed that "no easy generalization is possible". They underscored the importance of initial conditions, nature of distortions, and degree of disequilibrium in a given country, implying that different sequencing and speed paths will have to be adopted for the economic reform to be effective.

A summary of the comparative study of the economic reform of Chile, Korea and Turkey is given below to shed some light on the problem of phasing and speed of reform.

**Speed, Sequencing, and Some Results**

	Speed of the Trade Reform	Speed of the Domestic Financial Reform	Sequence Capital Account/ Trade Account	Sequence Labor Market/Trade Account	Sequence Trade Account/ Financial Reform	Export Performance	GDP Growth	Adjustment Costs
KOREA	Gradual	Very gradual	No real capital account reform	Labor market reform before	Together	Steep increase	High levels Increasing trend	Not important
TURKEY	Gradual	Rather quick	Capital account reform after the start of the trade reform	Labor market reform before	Together	Steep increase	High levels Increasing trend	Not important
CHILE	Quick	Quick	Capital account reform after the trade reform	No reform of the labor market	Together	Initially steep increase	High levels until 1981 Decreasing trend after 1977	Important

Source: Gropello, 1992, p. 31.

**3. THE CHALLENGE OF SEQUENCING AND SPEED OF ETHIOPIA'S ECONOMIC REFORM**

**3.1 The Setting**

The economic background to the reform exhibited the following main features:

- . The economic legacy was a very poor one.
- . GDP grew only by 1.5% during 1974-90.
- . Per capita GDP fell by 1.4% per annum.
- . Had the pre-1973 growth in income per head been maintained, an Ethiopian could have been twice better off than he/she was in 1990.
- . Severe fiscal imbalance.
- . Severe balance of payments problem.
- . Widened saving gap.
- . Massive dislocation, drought and war.
- . Low capacity utilization in manufacturing.
- . Food deficit.
- . Growth of the underground economy.

### **3.2 The Problem of Economic Recovery and Growth**

Given the shattered state of the economy, it is imperative that something has to be done sooner than later. To this effect, Ethiopia has initiated a far-reaching economic reform to stem and reverse the economic decline and put the economy on a sustained path of growth. Given the severity of the crisis, decisive moves towards implementation is imperative. Here, just as in other countries, the question of phasing and speed of the economic reform has to be tackled.

The basic objective of the new economic policy is to transform the Ethiopian economy from centrally controlled and managed to a market-based one. This requires adjustment of the whole economic system rather than just reforming of policies in the existing economic system. This is definitely a process, and some reforms are bound to take longer than others. As such, reforms need to be sequenced over time in a way that is consistent with the overall direction of the economic reform. What sequence should economic reform in Ethiopia take? Here are some perspectives that may be deemed to serve as useful indicators.

### **3.3 The Phasing and Speed Problem**

For Ethiopia's economic reform to be effective, it is suggested that it should take the following sequence:

**PHASE 1: Jump-Start the Economy**

- Emergency Recovery and Reconstruction Project (ERRP)

**PHASE 2: Start Structural Adjustment**

- legal reforms
- regulatory reforms
- agricultural pricing and marketing
- market entry and exit barriers

**PHASE 3: Macroeconomic Stabilization**

- reduce fiscal deficit
- monetary policy
- exchange rate action
- social safety net
- increase external resource flows

**PHASE 4: Continue and Intensify Structural Adjustment**

- public enterprise reform
- financial sector reform
- price liberalization
- tariff reform
- trade reform
- transport reform

These stages are not distinct and separate. They are supportive, complementary and overlapping. Earlier phases are meant to create conducive situations for reforms that come at later stages.

### **3.4 Major Elements of Each Phase**

#### **3.4.1 Jump-Start the Economy**

The economy is in severe internal and external imbalances, widespread destruction caused by the war, massive social dislocation, and extensive low capacity utilization mainly due to foreign exchange constraint. Under these circumstances the immediate priority is to jump-start the economy which is in a 'coma' - to borrow a medical term.

The Government's recovery and reconstruction plan, the World Bank-supported, multi-donor ERRP involving about US 680 million dollars, could be viewed as a priority step in this direction. The ERRP is bound to improve capacity utilization in the economy.

The ERRP has three main components. The production component tends to provide critical inputs for agriculture, industry and construction. The social services sector element will attempt to meet reconstruction needs in education and health and provides medical supplies and drugs. It also creates social fund to assist community-based income-generating activities for dislocated people, including former soldiers. The infrastructural component addresses reconstruction of roads, water and power supplies, and telecommunications. The transport sector also benefits from ERRP through provisions of new trucks, tyres, spare parts, as well as fuel.

All said, ERRP will provide a strong impetus to the recovery of the economy. In so doing, it creates a favorable environment for the macroeconomic stabilization measures to be taken to correct the internal and external imbalances. It contributes to the improvement of supply, government revenue and inflation. These, in turn, help to lessen the intensity of fiscal tightening and exchange rate adjustment needed to correct the imbalances. This implies also that the short-run social cost could be less and bearable.

#### **3.4.2 Start Structural Adjustment**

Structural adjustment is designed to improve resource allocation and efficiency. It is a long-term matter. It should, therefore, start as early as possible. But it should start with those measures that complement the stabilization effort. These are primarily those that help create an enabling environment for the development of the private sector that will contribute to self-sustaining economic growth. Early actions should tackle price and distribution controls, entry and exit barriers, limits on the size of firms, restrictions on ownership and area of investment.

The investment law, enterprise law, tax reductions, liberalization of licensing, etc. are important measures already taken to change the legal and regulatory framework of the economy. Peasants are ensured tenure security. Liberalization of agricultural pricing and marketing has been effected. All of these measures contribute to supply response and private sector development.

The selective decontrol of prices and the elimination of the centralized transport allocation system are also important measures towards reinstating the market and phasing out of the dual market structure which is the legacy of past policy distortions.

In the financial sector, a new interest rate structure has been introduced to eliminate the existing discrimination in the rates with respect to ownership and sector. The past interest rate policy heavily discriminated the private sector.

The introduction of a new labor law is also another measure that should come early in the reform program. It will introduce flexibility and mobility in the labor market. The necessary action has already been taken in this area too.

### **3.4.3 Macroeconomic Stabilization**

Here there are five major areas of concern. These are:

- a) Fiscal Policy;
- b) Monetary Policy;
- c) External Sector;
- d) External Resource Flow; and
- e) Social Safety Net.

Fiscal Policy will generally be tight, especially domestic bank financing of the deficit will be reduced. However, the overall budget deficit will still remain relatively high in the early period due to the need of rehabilitation and reconstruction. Foreign financing is expected to cover this aspect and hence the inflationary impact of high overall deficit. This will be backed by rationalization of government expenditure as well as the tax system to widen the tax base and hence revenue.

Monetary Policy will ensure that the expansion of money supply is in line with the objectives of fighting inflation and reducing pressure on the balance of payments. This is bound to entail reduction in credit going to the government to make room for increased credit availability to the private sector.

The exchange rate has been adjusted so as to redress the external imbalance and encourage exports and minimize smuggling.

Stabilization measures, exchange rate adjustment in particular, have to be supported by increased external resources if they are to be sustained to provide improved incentives.

Ideally, external resources should be available at the time actions are taken, if not it should immediately follow. Most reforms suffer slippage and reversals precisely because of problems related to external resources inflow.

Besides, because of the short-run costs of stabilization, safety-net measures should also be in place in tandem with stabilization to help deal with effects of inflation, problems of retrenchment, etc. Safety net for drought victims and dislocated people ought to be in place.

#### **3.4.4 Continue and Strengthen Structural Adjustment**

Once stabilization measures are taken, work should continue on structural measures. These include restructuring banks, food and conservation strategy, human resource development, civil service reform, population, energy, public enterprise reform, tariff reform, etc. In this regard, the importance of peasant agriculture cannot be over-emphasized. It is the source of growth for the Ethiopian economy.

### **4. CONCLUDING REMARKS**

The issue of phasing economic reform has become just as critical as articulating and implementing appropriate economic policies. Experience has shown that initial conditions influence the policies and the order that should be followed. As such this would differ among different economies.

In Ethiopia, inevitably the initial accent was in jump-starting the economy. In so doing, it creates a favorable environment for the macroeconomic stabilization measures to be taken to correct internal and external imbalances as well as structural adjustment. In practice these phases are not distinct, they do overlap. The Ethiopian economic reform does appear to exhibit the phasing described in this paper. It seems that the timing and sequencing of the reform measures is guided, more than anything, by the nature of the economy and special circumstances of the country.



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