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WP/94/101

INTERNATIONAL MONETARY FUND

Policy Development and Review Department

Sequencing of Financial Sector Reforms: A Review 1/

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September 1994

Abstract

This paper provides a review of the literature on both analytical issues and country experiences on the sequencing of financial sector reforms. It discusses the choice between big-bang and gradual reforms, the relationship of financial sector reforms to other economic reforms, the internal sequencing of financial sector measures and the influence of initial conditions. It is concluded that a pragmatic approach to the sequencing issue is necessary as there are only a few general principles valid for all countries.

JEL Classification Numbers:

E5, G1, G2WP/94...

1/ The author thanks P. Gajdeczka, Omotunde Johnson, Barry Johnston, Jan Mikkelsen, Kanitta Meesook, Rakia Moalla-Fetini, Chanpen Puckahtikom, Robert Rennhack, and V. Sundararajan for comments. Any remaining errors are the sole responsibility of the author.

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Summary

This paper provides a review of the literature on both analytical issues and country experiences with respect to the sequencing of financial sector reforms. It discusses the choice between "big bang" and gradual reforms, the relationship of financial sector reforms to other economic reforms, the internal sequencing of financial sector measures, and the influence of initial conditions. The paper concludes that a pragmatic approach to the sequencing issue is necessary, as there are only a few general principles valid for all countries.

One important principle seemingly valid for all cases is the need to accompany financial sector liberalization with the introduction and/or the enforcement of an adequate degree of prudential regulation and supervision. This is not a panacea, however, and consideration must also be given--especially in backward and emerging financial markets--to establishing procedures for imposing discipline through the development of markets and associated institutions. A related finding derived from experience is that delays in addressing the problem of failing financial institutions and in eliminating the causes of this problem can be very costly in terms of both fiscal resources needed for the eventual rescue and the malfunctioning of the liberalized financial markets.

Macroeconomic stabilization--always a worthwhile objective in its own right--can also help substantially in alleviating the problems of transition to a liberal financial system, and in maintaining the efficiency of the system once the liberalization has been completed. The transition generally has the temporary effect of increasing the rate of credit expansion above that of deposit creation; this expansionary effect must be offset through the use of newly created indirect instruments, but in a manner that avoids the risk that real interest rates might rise to very high and unsustainable levels. In addition to this transitory increase in liquidity, financial sector reforms may involve significant budgetary and real sector adjustment costs. These costs, although transitory and smaller than the long-term benefits, will likely affect the political determination to carry out the reforms and, therefore, the speed and sequencing of the measures.

Some common sense rules on sequencing can also help to avoid major policy errors, including the implementation of mutually inconsistent measures, which hardly promote the financial sector objectives, and premature liberalization measures, which crucially harm objectives in sectors other than the financial sector. These types of inappropriate sequencing can increase the risk of a financial crisis. Finally, the paper suggests that structural linkages among specific reforms (for instance, monetary instruments and money market structure) could dictate a specific sequencing of measures to ensure efficient implementation.

I. Introduction

This paper provides a review of the literature on both analytical issues and country experiences on the sequencing of financial sector reforms.

The issue of the appropriate sequencing of financial sector reforms arises when it is decided, for whatever reason, that a gradual rather than a big-bang approach will be used. Thus, the first question that must be faced is that of determining the relative urgency and speed of reforms and clarifying the reasons for preferring a big-bang or a gradual approach. Also, as financial sector reforms are generally part of overall economic reform efforts, the proper relationship of financial sector reforms to other reforms is a relevant consideration. These issues constitute the contents of Sections II and III, respectively.

In gradual reforms, issues arise about the logical sequence of financial sector measures, as well as the connections with other reform measures outside the financial sector that complement financial sector reforms. An answer to these questions requires detailed knowledge of the initial conditions of both the financial sector and the economy as a whole, as well as the ultimate objectives of financial sector reforms (the desired final conditions). These issues are discussed in Section IV.

The last section draws some conclusions about the sequencing of financial sector reforms based on both analytical and practical considerations and in the light of studies of experiences in countries that have undertaken financial sector reforms. It will be shown that a pragmatic approach to the sequencing issue is necessary as there are only a few general principles valid for all countries.

Before commencing the discussion, it will be necessary to provide a definition of the scope of financial sector reforms contemplated in this paper, their objectives and the various elements of which they generally are composed. In this paper, financial sector reforms mean changes of the financial sector toward a full-fledged and efficient market system. ^{1/} This includes but is broader than financial liberalization, that is, the removal of regulations that limit competition in the financial system and that impede the free interplay of market forces either in determining the

^{1/} This paper follows a broad definition of the financial sector, which is construed to comprise the monetary authorities (central bank, superintendency of banks, deposit insurance agency, stock exchange commission), banks, nonbank financial institutions including quasi-banking institutions and insurance companies, and stock exchange markets. However, most of the discussion in Sections II and III is cast in general terms and assumes away any differences between financial institutions and between monetary authorities.

prices (interest rates) of financial contracts, or their quantities. Reforms are broader than mere financial liberalization because the latter, in fact, increases the risks for financial institutions and, therefore, requires that the authorities step up efforts to discourage excessive risks through increased prudential regulation and supervision. This is in fact the main--some would say the only--general conclusion that can be derived from experience. In addition, under financial liberalization the authorities need to take measures to maintain competition in financial markets, for instance, by licensing new domestic and foreign financial institutions and deterring or penalizing collusive practices among financial institutions. 1/

Regarding the objectives, from the outset this paper will assume that financial sector reforms are a worthwhile endeavor. Therefore, it will provide little discussion about the rationale for reforms, which is by now well established, if not universally shared. Briefly, as in the case of other reforms designed to foster the market economy, financial sector reforms are oriented toward improving economic performance by raising efficiency and lowering costs. In particular, a liberalized financial sector can strengthen allocative efficiency and raise the productivity of investment by increasing the volume of financial savings and improving its allocation to the most efficient uses (Fry (1993); Galbis (1977)). 2/ Under this assumption, the main issues in this paper are how fast and in what order or sequence, if any, should the different reform measures be undertaken.

The elements of financial sector reforms are hereby defined as the various policy, regulatory or administrative measures or undertakings required for achieving the objectives in a satisfactory manner. The elements can be broadly classified in four categories according to their main function, although some of them do not fit neatly in any of them and involve more than one category depending on the emphasis of the policy maker. First of all, there are liberalization measures: liberalization of interest rates of bank and nonbank financial institutions; removal of interest rate subsidies provided by the central bank; reduction in the level of reserve and liquidity requirements imposed on financial institutions to the levels consistent with prudential considerations and monetary policy effectiveness; and elimination of selective credit regulations. Second, there are measures to develop financial markets and establish monetary control in a liberal environment: development of money markets, including the interbank market, the treasury bill market, and the market for trade bills; shift from direct to indirect monetary policy instruments; reform of monetary control procedures; broadscale reforms of the payments system; and

1/ See further below for a more detailed description of the various elements of financial sector reforms.

2/ In a liberalized financial system the volumes of saving and investment are not necessarily correlated with the real rate of interest. The emphasis is thus on the productivity of investment rather than its volume.

developments of securities and capital markets including stock exchange markets. Third, there are the elements necessary for strengthening of prudential regulations and the supervisory system, which comprise recapitalization of financial institutions, including, if needed, the central bank; restructuring and/or liquidation of unsound financial institutions and introduction of an explicit deposit insurance scheme. Fourth, there are measures to strengthen competition in financial markets, that is, among banks, between banks and other financial institutions; and between the financial system and the capital markets; privatization of publicly owned financial institutions; and licensing of new domestic and foreign financial institutions.

The above list is not exhaustive. The sequencing of the various elements of the reform in any given country will depend on the general orientation of its economic policies, the priorities perceived by the authorities in the financial area, and most of all on the initial conditions. For the sake of simplicity, this paper often distinguishes between three broad groups of countries with different initial conditions: industrial countries, developing countries, and transition economies. The intensity of reforms at present is greatest in transition economies, which are taking significant measures in all four of the above categories.

II. Big-bang Versus Gradual Reforms

The analytical literature on economic reforms sometimes has made a distinction between big-bang and gradual reforms. However, this literature has thus far focused only on general issues in the liberalization of various economic markets: domestic goods markets (domestic prices), external current account (quotas, tariffs, and exchange restrictions), domestic financial markets (interest rates), and external capital markets (liberalizing capital controls). Therefore, the arguments in this section apply to economic liberalization in general and not only to financial sector liberalization, much less overall reform. In fact, in the area of financial sector reforms, the analytical literature has not yet dealt with the various elements of these reforms, but only with their most egregious macroeconomic aspects: the liberalization of interest rates, that is, the removal of legal and administrative constraints to the market determination of interest rates. ^{1/}

It is obvious that, while the issue of sequencing is potentially relevant to the gradual approach, it is of little relevance to the big-bang approach. In principle, in a big-bang approach all the elements of the reform should be put in place at once. In practice, it is difficult to find a clear-cut case of the big-bang approach, although some actual experiences can be cited which would approximate the definition (see below). Any delay in the implementation of some elements could potentially compromise the big-

^{1/} At this level of abstraction, there is no mention of complementary elements of the reforms such as those discussed in the Introduction.

bang approach and, in fact, turn it into an involuntary gradual reform, which would potentially raise the question of the appropriate sequence of measures. Even on a cursory inspection, it seems certain that, whereas financial liberalization (narrowly conceived as the freeing of interest rates) could, if desired, be achieved by one single set of measures, most of the complementary reforms would inevitably take time.

Several authors have pointed out that a big-bang approach would be optimal from an economic point of view in the absence of market distortions and/or externalities (Choksi and Papageorgiou(1986); Edwards(1986); and Mussa(1982)). In this case all the markets should be liberalized at once since there would be immediate benefits to the liberalization and no costs. 1/ It should be added that a big-bang approach would also be preferable from an strictly economic point of view if policymakers faced complete uncertainty about potential distortions and externalities, to the extent that they could not be identified empirically, much less measured quantitatively.

Even if there are identifiable and measurable market distortions and/or externalities that require a gradual approach from a purely economic point of view, 2/ the introduction of political economy considerations can have the effect of making a big-bang approach superior in an overall sense (Lal (1987); and Martinelli and Tommasi (1994)). This is so because the gradual approach may be incompatible with the full implementation of the program if at one of the stages of its implementation a coalition of interests emerges with sufficient power to block the reforms to be carried out at that stage. This would cause some of the benefits of the program to be lost and the overall effect could be to reduce the value of the package to below that of a big-bang implementation. Research has indicated that the simultaneous implementation of all stages tends to increase the probability that agreement will be reached among all the various groups concerned because there will be offsetting costs and benefits to the participants derived from the different elements of the program. For this reason, it has been argued, although it sounds paradoxical, that a big-bang approach may be specially suited to the needs of democratic governments with relatively weak power, which in order to succeed will have to try to form a grand coalition of opposing interests that may secure simultaneous implementation, given their inability to confront interest groups in isolation on their attempt to block individual measures of the package.

These political economy arguments for a big-bang approach to liberalization are also complemented by arguments relating to the credibility of the reforms. To the extent that speed, comprehensiveness,

1/ However, economic optimality may not ensure the immediate application of measures, as there may be political forces opposed to it.

2/ A gradual approach would be one in which all markets are not liberalized instantaneously but slowly and/or possibly following a preferred sequence.

consistency, and sustainability are perceived as being related to credibility, a big-bang approach will be superior to a gradual or phased approach. The point has also been made that democratic governments face a definite time horizon beyond which they cannot guarantee their control over the process.

Despite these abstract analytical considerations in favor of a big-bang approach, most of the literature--especially the empirical literature on developing and transition economies--assumes that there are in fact economic, technical, and sometimes political reasons to follow a gradual approach and, therefore, this literature attempts to determine the appropriate sequencing of reforms. The first issue that arises in this context in relation to financial sector reforms is the temporal relationship that these reforms may have with reforms in other areas. This issue is explored next.

III. Relationship to Other Economic Reforms

Several recent contributions have pointed out two major preconditions of financial sector liberalization: macroeconomic stability and achievement of strong prudential regulation and supervision (McKinnon (1988; 1991b); Leite and Sundararajan (1990); Villanueva and Mirakhor (1990); Mirakhor and Villanueva (1993); and Fry (1993)). If taken literally, no country should undertake financial sector liberalization without meeting these two preconditions. ^{1/} However, this would set a very strong standard and would eliminate practically all big-bang liberalizations and possibly also some gradual ones. Experience suggests that weaker criteria can suffice. For instance, one has to consider at least the possibility that these "preconditions" may be phased in simultaneously with the start of financial liberalization.

1. Prudential regulation and supervision ^{2/}

The development of policies to ensure the stability of the financial system is of paramount importance. The failure of a bank, even if small, may lead to contagion and loss of confidence in the system. The system's failure may lead to disturbances in the money supply, or failure of the payments system, a detrimental effect on the real economy, and direct or implicit obligations on the part of the government. Therefore, strong prudential regulation and supervision over the financial sector is generally

^{1/} For an overview of experience with financial sector reforms in both industrial and developing countries, see Watson (1993). He also recognizes these two "preconditions" but seems to allow for the possibility that all these reforms may be staged simultaneously.

^{2/} Note that in fact this precondition pertains to an element of the financial sector reforms themselves and not to reforms in some other areas such as, for example, trade and fiscal consolidation.

recognized as essential for all countries, be they industrial, developing or in transition. 1/ Furthermore, the need for prudential regulation and supervision tends to increase as the financial sector is liberalized, because liberalization increases the risks borne by financial institutions, so that the authorities will have to step up efforts to control these risks and to deal with problem institutions that may nevertheless incur losses owing to the materialization of these risks. 2/

Thus, with regard to the industrial countries, a common thread that has been found to operate in relation to the deterioration of bank balance sheets beginning in the 1980s "is the recognition that the competitive pressures unleashed by financial liberalization do not merely increase efficiency: they also carry risks, as banks and other financial institutions alter their behavior to ward off institutional downsizing" (Goldstein and Folkerts-Landau (1993), pp. 2-3)). These competitive pressures are found to be the primary cause of the recent banking problems observed in some industrial countries. 3/ Stronger prudential regulation and supervision is, therefore, found to be needed in these countries to identify and control such risks, including through adequate bank capitalization, restructuring of troubled institutions, and orderly liquidation of failed institutions.

A similar finding has been noted in relation to the experiences with financial liberalization in developing countries, especially the early experiences of the 1970s and 1980s of Argentina, Chile, Uruguay and the Philippines which terminated in financial sector crises and a reversal, albeit temporary and partial, of liberalization (Sundararajan and Baliño

1/ For an overview of issues in prudential regulation and supervision, see Polizatto (1992). Prudential regulation refers to the laws, rules, and regulations designed to minimize the risks assumed by financial institutions and to ensure the safety and soundness of both individual institutions and the system as a whole. Examples include, inter alia, criteria for sound entry of new institutions; lending limits to individual or group borrowers and especially insiders; minimum capital adequacy standards; liquidity ratios; asset classification and provisioning; scope, frequency and content of the audit program; treatment of problem and failed banks; enforcement powers; and deposit insurance. Banking supervision refers to the monetary authorities' ongoing monitoring of banks and enforcement of banking regulations and policies.

2/ Financial liberalization requires substantial changes in the scope of bank regulation and supervision. More emphasis has to be placed on monitoring the liquidity and soundness of financial institutions (in addition to compliance with monetary and prudential regulations), and on the use of on-site inspections together with off-site general surveillance systems.

3/ The countries covered in this publication are Finland, Norway, and Sweden, which suffered severe crises; Japan and the United States with less intense problems; and France and the United Kingdom with some emerging problems.

(1991)). In all these cases, prudential regulation and bank supervision had been either neglected or broken down during the process of liberalization.

The experience of the transforming economies is even more dramatic; not only did they start their financial sector reforms from a position in which the financial sector was riddled with significantly bad loan portfolios (loans that had been granted to state-owned non-performing companies) but also their financial sectors continued to get into deeper problems as they continued to extend non-performing loans. In these countries, often the regulatory and supervisory systems were very poor as they did not just have to be improved, they had to be created practically de novo. Thus, there is no question that one of the necessary elements for successful liberalization in these countries is a rapid development of the appropriate dose of the relevant prudential regulation and supervision.

There is also no question that the "appropriate" dose of prudential regulation and supervision is easier to recommend than to apply in practice. The authorities must be careful that prudential controls and supervision are neither excessive (in which case they may stifle competition) nor insufficient (that is, inadequate to protect the safety and soundness of individual institutions and the system as a whole). In addition, because the nature of bank regulation and supervision needs to be constantly adapted, first to enter financial liberalization and then to follow the continuous development of the markets under financial liberalization, it is not possible to establish once-and-for-all the "right" type of supervision before the financial developments that make it necessary. In a way, the authorities--like market participants themselves-- must always be learning and adapting to the changing circumstances, and, therefore, prudential regulation and supervision is more of a process of learning-by-doing than a pre-set activity.

The lesson that arises out of the experiences of countries in financial crisis is not necessarily the need for them to delay financial liberalization, but how to manage dynamically to introduce and adapt prudential regulation and supervision to preserve the integrity and efficiency of the markets and to prevent the possible adverse consequences of financial liberalization on the viability of financial institutions. In this regard, the issue has been raised whether liberalization in a big-bang fashion is appropriate for transition countries, given the risk that they may not be able to introduce sufficiently strong prudential regulation and supervision in time. Because of this, some recent contributions have tended to be cautious and in fact recommend against big-bang liberalization in these countries (Calvo, Kumar et. al.(1993)). However, the issue is not entirely clear in all cases and will depend on the implementation capacity of each country to establish and maintain adequate prudential and supervisory systems.

This diversity of situations is even more true for the developing countries, which may start from very different initial positions with regard to the solvency of financial institutions and the effective capacities to

redress this situation by reinforcing prudential regulation and supervision. Therefore, the speed of liberalization will have to be tailored *inter alia* to the particular circumstances of each country regarding its capacity to implement at least a minimum effective standard of prudential regulations and supervision.

2. Stable macroeconomic environment

The precondition that there be a stable macroeconomic framework (which is viewed by most as meaning a low inflation rate and as being closely tied to fiscal consolidation) is less obviously necessary, although there is no question that it is desirable. ^{1/} In fact, with low inflation and small and sustainable budget deficits the chances that a financial liberalization will result in sustainable (positive but moderate) real interest rates are high; and under these conditions the credit risk problem will be significantly minimized, so that it will turn out to be easier to combat emerging financial sector problems through prudential regulation and supervision. However, the issue remains what to do about domestic financial liberalization (and also external financial liberalization, see below) in those countries in which inflation is still raging and, worse still, in which there is yet little hope that the authorities will have either the political will or the means of controlling the budget process and inflation in the foreseeable future.

The correct answer in these circumstances cannot be to wait forever until the economy is stabilized. Nobody would deny that in order to establish positive real interest rates it is better to reduce inflation--if

^{1/} This precondition has been defended especially by McKinnon (1982;1988; 1991a). He has insisted that fiscal control is a precondition for domestic financial liberalization and that the onset of liberalization should be postponed until fiscal consolidation is achieved. This is based on the realistic assumption that financial liberalization will increase the budget needs and will, therefore, make monetary stabilization more difficult. (Note, however, that no capacity of contraction by the public sector is allowed for in this scenario, whereas in practice in some cases financial liberalization may be the most effective way of making the government more responsible.) Consequently, in his 1982 and 1988 contributions he suggested that the authorities need to keep ceilings on interest rates if there is macroeconomic instability, that is, budget deficits and inflation. (For a criticism of his 1982 and 1988 contributions see Stockman (1982) and de Macedo (1988), respectively). In his 1991a book he further questioned the desirability of freeing interest rates in the absence of prior fiscal consolidation. In this book he developed a proposal for staging a comprehensive package of economic reforms in four consecutive stages: fiscal control; opening of the domestic capital market; liberalization of the foreign exchanges on the current account of the balance of payments, and trade reform; and lastly, liberalization of the capital account of the balance of payments.

at all possible--than to raise interest rates. However, if this were the only choice, there would be little difference between the old interventionist attitude (which justified the need for a financially repressed economy until it was possible to eliminate inflation) and the new liberalization outlook. It is precisely to shield, at least partially, the financial sector from the negative effects of inflation that it becomes necessary to liberalize the financial sector even if, unfortunately, the inflation cannot be controlled. Thus, it can be observed that a large number of developing countries, both with and without Fund-supported programs, have freed interest rates and eliminated other nonmarket controls over the financial sector, without suffering a financial crisis, even though some of them have not yet managed to conquer inflation (Galbis (1993)). The best known example of this position is Brazil, which liberalized the financial sector already in 1975, although it has yet been unable to overcome fiscal expansion and inflation. Obviously, it would have been better if inflation had been tamed, but it would seem inappropriate to argue that under the circumstances the liberalization was ill-conceived. The country has muddled along the best it could under this second-best situation, given the fact that it was unable to move to the optimal position. It can be said that it has reaped many of the benefits of financial liberalization, despite the negative effects of inflation.

A different but even more favorable case for immediate financial liberalization is that of a country that is contemplating a simultaneous approach to liberalization and macroeconomic stabilization. This was the case of Bolivia in 1985 (Sachs (1986)). By mid-year, a severe hyperinflation was raging but the new democratic authorities mastered both the political will and the instruments necessary to produce a dramatic turnaround. This stabilization, which was one of the fastest and more dramatic in history, was accompanied by the sudden and complete removal of all interest rate controls and other nonmarket restrictions. Again, it would be difficult to find fault with this bold initiative, which quickly led to both price stabilization and positive real rates of interest. 1/

More generally, macroeconomic stability (low inflation) cannot be set as a necessary precondition for all cases because then many countries would have to wait a long time to get the benefits of financial liberalization. Such liberalization is possible and desirable (as a second best) even in the absence of assurances about the achievement of macroeconomic stability. What would seem necessary, however, is that macroeconomic policies--fiscal, monetary, exchange rate and wage policies--be coordinated in such a manner that their combined operation does not distort relative macroeconomic prices in a way that is detrimental to the business sector, because the failure of

1/ There were some post-liberalization difficulties --but not greater than in other countries-- especially in that high real interest rates persisted and that there was a substantial rise in nonperforming loans (Calvo and Guidotti (1991)).

the business sector inevitably carries with it the failure of the financial sector.

A case in point is what happened in Chile in the three years preceding the financial crisis of 1982, when the authorities were still struggling with stabilization. (Significantly enough, Chile had met McKinnon's "precondition" for sound financial sector liberalization cum stabilization, as it had achieved budgetary surpluses for a number of years preceding the crisis). Three basic parameters were set against the business sector (Galbis (1987)): real borrowing interest rates were very high, partly as a result of lack of policy credibility and partly as a result of accumulating nonperforming loan portfolios resulting from adverse credit selection in the absence of effective prudential regulation and supervision; real wage rates were increasing as a result of backward indexation of wages and declining inflation; and the real exchange rate was appreciating as a result of having fixed the exchange rate when inflation, albeit declining, was still high. These three adverse factors, when applied simultaneously, reduced business profits and made it impossible for business to repay loans; then lack of appropriate prudential regulation and supervision added another factor to the distressed business situation, as financial institutions continued to finance bankrupt businesses which largely owned the financial institutions (Galbis (1986)). ^{1/} This episode shows that the lack of macroeconomic stabilization, although not per se an insurmountable impediment to sound financial liberalization, poses many risks and in fact makes it even more necessary to apply strict prudential regulation and supervision over the financial sector.

3. External sector liberalization

The literature has also discussed extensively the possible need for sequencing of external financial liberalization--the capital account of the balance of payments--in relation to that of the domestic financial markets and the current account of the balance of payments. With exceptions, the literature has argued that capital account liberalization--a potentially crucial element of overall financial sector liberalization--should wait until completion of the entire process of other liberalization and reform measures and, in particular, until after the liberalization of the domestic financial sector (McKinnon (1982;1991a); and Blejer and Sagari (1987)) and of the current account of the balance of payments (McKinnon (1982; 1986; 1991a); Frenkel (1982); Edwards (1984;1986); and Edwards and van Wijnbergen (1987)). The argument in favor of delaying capital liberalization is partly based on the potentially destabilizing effects of reversible capital flows,

^{1/} In this situation the opening up of the capital account also had a negative impact because the flood of new money coming from outside was misallocated by banks in this highly distorted environment. As noted below, however, one cannot translate this unfortunate episode into a general prescription for not liberalizing the capital account until everything else is in order.

which can aggravate any adverse effects of domestic financial liberalization. It is also based on presumed externalities and asymmetric information which initially induce larger inflows than the receiving country can absorb productively. 1/

However, as several authors have pointed out in relation to the experience of Indonesia with an early liberalization of the capital account in 1971 (Cole and Slade (1992); Fischer (1992); and Quirk (1994)), the opening up of the financial sector to external competition and the early introduction of capital liberalization can in themselves be forces contributing to the acceleration of domestic financial sector reforms, as well as liberalization of the current account. This argument is reinforced by political economy considerations (Lal (1986; 1987)). The case for the current account precondition further revolves around the issue of the relative speed of adjustment of goods and financial markets; more time is needed to reach equilibrium in the real than the financial markets (Edwards (1986)). However, if the distortions caused by financial markets tend to aggravate rather than offset those of real markets, as it is often the case, there is no compelling reason to delay capital liberalization, just as there is no reason to delay domestic financial sector reform until after the distortions in the real sector are eliminated. In fact, the liberalization of the capital account, now completed by the industrial countries, was implemented in advance of full commercial liberalization. Thus, in general, and contrary to the literature, financial liberalization both domestic and external is achieved before real sector liberalization as governments often find it more difficult to abandon their real sector interventions. Financial liberalization, of course, cannot redress real distortions, but at least can avoid making them worse.

IV. Sequencing of Gradual Financial Sector Reforms

As the preceding section has shown, the optimal sequencing of financial sector and other reforms does not always equate to the most practical sequencing. There are only a few general principles applicable to all countries for deciding between a big-bang or a more gradual approach or for going ahead with financial sector reforms before or after other economic reforms. However, one general principle that has been established is that the need for appropriate prudential regulation and supervision of the financial sector is never in doubt. This need increases as the financial sector is liberalized. A big-bang approach would imply that advanced prudential regulation and supervision is already available to the policymakers or that they can make a quantum improvement in it. Otherwise, the liberalization might need to be more gradual. If at all possible, a program of macroeconomic stabilization should also be launched

1/ Some authors have gone as far as to question the desirability of capital account liberalization at any stage in the liberalization process (Dornbusch and Park (1987); and Park (1991)).

simultaneously with the introduction of financial sector liberalization. Nevertheless, deficiencies in prudential regulation and supervision and in the macroeconomic environment should not be used as excuses for delaying the liberalization of the financial sector. Perhaps the only case in which financial liberalization should be delayed is if both macroeconomic stability and adequate prudential regulation and supervision are starkly lacking.

Even if the "preconditions" are met, it cannot always be feasible or appropriate to introduce financial sector reform in a big-bang fashion. For one thing, it cannot be done without the requisite political support. More important, from the economic point of view, there can be practical obstacles such as a general lack of basic administrative capacity to manage the legislative and administrative changes required by the reforms, especially in low-income developing countries (Macroeconomic (1991)). Also, particularly in economies in transition, serious obstacles can be encountered because of the lack of even the minimal financial sector infrastructure that can provide the base for a financial market to function. In this regard, it is crucial to look at the initial conditions, not only of the financial sector, but of the entire economy, and also at the prospect for reforms in other areas. This then throws the course of the investigation toward gradual approaches, which after all are the more common.

1. Internal sequencing

Once a decision has been made to proceed with gradual financial liberalization, several measures must be taken and choices made. As discussed above, the general literature on financial sector reforms has already touched on two basic topics of the internal sequencing of financial sector reform: the general proposition on the immediate and universal need to create or adapt to a market-based system a comprehensive framework of prudential regulation and supervision (although not necessarily before the liberalization but along with it); and the proposition (controversial and less obviously generalizable to all countries) that the external financial liberalization--the liberalization of the capital account--should come last. In a liberalized financial system, regulation will be limited to pursuing the objectives of controlling the money supply process through indirect monetary policy instruments, ensuring the safety and soundness of the financial sector institutions, and encouraging competition in financial markets. ^{1/} Sooner or later all other regulations not needed for these purposes will have to be removed. This includes all kinds of selective credit policies, portfolio requirements on financial institutions, direct credit controls, and direct controls on interest rates.

An essential decision concerns the timing of interest rate liberalization. There is generally a choice between deregulating the rates

^{1/} This section will not repeat issues in prudential regulation and supervision which were already discussed in Section III.1.

of interest on the assets and liabilities of financial institutions and introducing new financial instruments outside the financial sector such as treasury bills and other government securities with market-determined interest rates. Both can be programmed simultaneously, or one can precede the other by a short time, and both can be done in a single sweep or more gradually. For example, in four of the five country experiences reviewed in detail by Bisat, Johnston and Sundararajan (1992)--Argentina, Chile, Indonesia and the Philippines--interest rates of the financial sector were liberalized (and direct credit controls abandoned in favor of indirect monetary policy instruments) before launching auctions of government securities (see also Johnston (1991) and Sundararajan (1992b)). In a fifth case--Korea--a gradual replacement of direct by indirect instruments was effected before the interest rates of financial institutions were freed.

In many countries, for instance, Japan, Spain, and the United States the liberalization of financial institutions' interest rates was a gradual process spanning many years, either in a pre-programmed fashion, like in the United States (1980-86), or in a more discretionary manner. In Spain the discretionary process of deregulation of interest rates lasted almost two decades (1969-87), while at the same time the interest rates on government securities were progressively left to be determined by market forces; the substitution of indirect for direct monetary policy instruments also was a protracted affair (Spitaeller (1992)).

Open-market operations--the most market-based indirect instrument of monetary policy--can function fully only if there is a secondary market for government securities, a market which can take some time to develop. But, meanwhile, the authorities can begin to gain experience with quasi-open-market operations based on primary issues of treasury bills or central bank bills (Lindgren (1991)). At this stage it is also necessary to develop other money markets including the interbank money market and a flexible market for rediscounts or other refinancing of the central bank, so as to be able to coordinate the various monetary policy instruments in a comprehensive financial program. ^{1/} For the longer run, however, two considerations tip the balance in favor of government securities and against central bank bills: first, government securities have a wider circulation range that includes the general public and, therefore, a greater potential to foster financial market development than central bank securities (and in turn the deeper and smoother development of government securities will facilitate the central bank's operations); and, second, there is a risk for central bank losses when central bank securities need to be issued in large amounts to absorb excess liquidity (Quintyn (1994)).

^{1/} Many countries undertake "open market type operations" using primary issues of bills or credit auctions or a combination of both as effective monetary control instruments. The type of operations will have to be tailored to the specific characteristics of the interbank money markets and the associated clearing and settlement system.

The introduction of indirect instruments requires a substantial change in the procedures and operating targets of the monetary authorities (Wong (1991;1992); and Khan and Sundararajan (1991)). It also requires that the formulation and implementation of financial programs be focused on the central bank's balance sheet because quantitative financial programming at the level of the financial or banking sector will no longer be practicable (Johnston (1993)). These reforms also make it necessary that public debt management and monetary management be properly coordinated (Leite (1992)). All these reforms are interconnected and some obviously depend on improvements in others, but there is no reason to start late in any of them; on the contrary, the sooner they are launched the better.

A practical rule that has generally been proposed and implemented in most countries is that the replacement of direct by indirect monetary policy instruments should not be effected before empirical confirmation of the working of indirect instruments is obtained. Thus, both systems should be run in parallel for a period that is sufficient to establish the effectiveness of indirect instruments, before abandoning the direct instruments. The direct instruments often remain a contingency in case of major disturbances until the indirect market-based instruments--the ones that take the longest to introduce--are firmly in place (Lindgren (1991)). As an alternative to the simultaneous use of both types of instruments, it has been argued that the introduction of indirect monetary policy instruments should be made early in the liberalization process in order to have the means of offsetting the initial transitory increase in credit that accompanies the lifting of direct credit controls (Bisat, Johnston, and Sundararajan (1992)).

Based on the experience of 19 low-income countries with programs of structural adjustment, a recent study (Schadler et. al. (1993)) arrived at the following conclusions in regard of the actual sequence of financial liberalization measures. First, much progress was made in establishing positive real interest rates, in some cases by administrative fiat but in most others through straight liberalization of rates cum introduction of treasury bill auctions. Second, the shift to indirect monetary policy instruments progressed more slowly than interest rate liberalization. Third, the elimination of quasi-fiscal activities and improvements in banking practices were slow; there were fears that the elimination of subsidized and directed credit would compromise producers in the affected sectors. Finally, the restructuring and strengthening of financial institutions--despite the priority that is assigned to this aspect of reform which is closely related with the improvement in prudential regulation and supervision--was a protracted process, partly because of the continuing demand for bank credit on the part of weak public enterprises.

A much debated issue concerns the possible introduction of explicit deposit insurance schemes. Many authors view this as a less pressing need (e. g., Calvo, Kumar et. al. (1993)) and even as a possible interference with a liberalized financial system (Vittas (1992)). However, in light of the fact that "implicit" deposit insurance is pervasive in virtually all

countries because the authorities can hardly afford not to rescue insolvent institutions, especially if they are viewed as "too big to fail" or if there are many simultaneously in trouble, some authors have insisted on the virtues of an explicit deposit insurance system designed to limit the deposit insurance benefits, to raise at least part of the revenues needed to confront problem banks, to reduce the implicit protection of shareholders and managers of financial institutions, and to strengthen the motivation of the monetary authorities to implement strong prudential regulation and supervision (Galbis (1988); Talley and Mas (1992)).

The area of competition policies is one in which not only simple issues but also some complex ones have arisen. It is generally agreed that competition is more likely to be effective when the system is composed of private institutions than when they are mostly or partly public. Hence the view that privatization of financial institutions is an important element of reform in countries with a tradition of public ownership. Competition is also promoted by effective rules for entry of new private financial institutions--rules that make it easy and virtually costless to enter but which, at the same time, weed out potentially troublesome entrants. More controversial is the issue of whether universal or specialized banking encourages effective competition. On the one hand, by permitting a wider range of action for all financial institutions, a universal banking system appears in principle to be capable of increasing market competition. On the other hand, if carried to extremes, universal banking could make the system prone to the formation of groups or conglomerates capable of deriving market power and that would be less transparent than simpler institutional forms to the scrutiny of supervisors and market regulators.

The development of long-term securities markets has attracted increasing attention. Partly as a result of market innovations, a clear tendency has been observed in industrial countries during the last 15 years or so, for the financial system to expand more in the area of securities markets and less in the area of banks and similar financial institutions. This has broadened and deepened competition, but at the same time it has brought about new concerns, requiring improvements in prudential regulation and supervision, activities which in this area are normally carried out by autonomous agencies of the type of securities and exchange commissions. ^{1/} Until recently, by contrast, the literature on developing countries hardly mentioned the need for the development of capital markets, under the implicit assumption that in these countries these markets are less important than those engaging banks and similar financial institutions and that they belong into a later, more advanced stage of the development process. However, this assumption is being challenged by recent studies that point

^{1/} This paper does not cover issues in international capital markets, which are rapidly increasing in size and complexity and also pose numerous issues for prudential regulation and supervision. For a review of these issues, see IMF, World Economic and Financial Surveys, International Capital Markets (yearly).

out the significant development of securities markets--both bonds and stocks--that has taken place in some developing countries, and its contribution to economic development (Feldman and Kumar (1994)). In the transforming economies, the need to pay attention to the early development of the capital market to encourage industrial finance in parallel with the more cautious development of the financial sector has been emphasized (Calvo, Kumar et. al. (1993)).

2. Influence of initial conditions and ultimate objectives

The initial conditions (starting point) and the ultimate objectives (final point) determine the magnitude of the task to be accomplished and in some cases also the most likely sequence of measures.

The situation of the transforming economies at the beginning of their respective reforms was one in which financial institutions and financial instruments had to be created de novo and not merely reformed to conform with market principles (Sundararajan (1991;1992a); Calvo, Kumar et. al. (1993)). 1/ The monobank structure had to be separated into a central bank and commercial banks, while allowing for the entry of new banks, including foreign ones. At the same time, the new institutions and instruments had to be regulated by enactment of central banking and commercial banking legislation. All these actions logically had to precede the operation of financial markets and the attempts to conduct monetary policy through indirect monetary policy instruments.

Furthermore, there was the need to clean up from the outset the commercial banks' bad assets that had been spun off from the monobank structure and to establish new systems to prevent the making of new bad loans. In particular, this situation of widespread insolvency of financial institutions called for extra care in establishing monetary control. A premature launching of an indirect, auction-based monetary control system could result in severe problems of adverse credit selection, moral hazard or collusion among the institutions allowed to participate in the central bank credit auctions. To avoid these problems the authorities might have to either continue to use direct instruments such as credit ceilings, or introduce a two-tier banking system with central bank credit provided only to first-tier solvent banks (Mathieson and Haas (1994)). Alternatively, in some cases it might be possible to use credit auctions but with certain special features regarding access rules, collateralization and auction procedures designed to ameliorate or prevent some of the problems associated with information and incentive deficiencies (Saal and Zamalloa (1994)).

1/ McKinnon (1991a) stands alone in suggesting that in transition economies the monobank system could serve well in the initial stages of financial sector reform and should not be altered until the problem of nonperforming loans and soft budget constraints is solved.

In addition, without the hardening of the soft budget constraint facing nonfinancial enterprises, there was a high chance that the financial institutions' portfolios would continue to deteriorate after the cleanup of the financial sector (Hardy and Lahiri (1992); Calvo, Kumar et. al. (1993); Bredenkamp (1993); Fries and Lane (1994)). 1/ Needless to say that this hardening of the budget constraint would involve an overhaul of the entire structure of the economy and, in particular, the liquidation of insolvent nonfinancial firms and the restructuring of those that might become viable, so that they could be commercialized and privatized. The origin of this historically unique situation had been of course the removal of the command price system, with its attendant subsidies and penalties, and its replacement by a system of market prices determined competitively in world markets. This had also brought about in the initial stages a sharp increase in the overall price level, and the subsequent inflation had made structural reform more difficult. In these circumstances, there has been a certain inclination to recommend the postponement of full financial sector liberalization, including in particular that of interest rates and their increase to positive real levels (McKinnon (1991b); Hardy and Lahiri (1992); Bennet and Schadler (1992)). It has also prompted renewed calls to focus monetary policy first and foremost on overall price stabilization including, if possible and necessary, through the introduction of a currency board system before its transformation into a full-fledged central bank (Guitian (1992); Rostowski (1994)). 2/ Another issue demanding urgent attention became that of introducing a safe and efficient decentralized payments system designed to control payments' credit, liquidity, and operational risks in the new market environment (Hook (1992)).

In this atmosphere of urgency caused by so many immediate reform needs in so many areas, the issue of the privatization of financial institutions (mainly banks) span from the old centralized system, became of lesser immediate priority. Privatization in the financial area was delayed, as it also happened in the case of nonfinancial enterprises, by the need to bring up the institutions to a minimum standard of solvency before privatization could be achieved, and by the lack of development of a market for shares. In addition, there were fears that early privatization of financial institutions might aggravate the problems encountered in regulating and supervising these institutions.

The situation of the industrial countries on the eve of their respective liberalizations of the financial sector was vastly different.

1/ The initial unsound situation of financial institutions and nonfinancial enterprises poses the risk that an increase in interest rates will accelerate the rate of credit creation (needed to keep bad borrowers afloat) and inflation, without any improvement in credit allocation. If this occurs it will also increase the cost of the eventual government bailout.

2/ For an examination of the currency board system established in Estonia see Bennet (1993).

Relatively flexible financial institutions and instruments had existed for a long time and the macroeconomic situation appeared to be stable subject, of course, to yet uncontrollable cyclical fluctuations. Most of them also had a reasonable level of bank prudential regulation and supervision. ^{1/} Therefore, for these countries the situation appeared to be favorable for an immediate financial sector liberalization. In many of them the choice between a big-bang liberalization and a more gradual one had been for a long time largely a matter of political will and opportunity. The precipitating factors for liberalization were in some cases the dynamics of the markets, which progressively learned to circumvent domestic controls as well as restrictions to the free movement of capital across external borders.

In the developing countries the situation of course varied a lot but essentially, except for some low-income ones, many started from a situation not completely different from that of the industrial countries. They had a system of financial institutions and instruments and a system of prudential regulation and supervision capable of being adapted to the needs of the market. It was a matter of liberalizing the interest rates of financial institutions (including interbank market rates) and introducing a market for government securities while removing nonmarket regulations such as credit and portfolio guidelines. There is as yet no precise economic explanation for the disparate rates of financial liberalization between countries and even less for the fact that some have virtually gone very quickly and all the way while others are only now beginning. It is often argued that the latter countries had reasons to be cautious because they had tended to suffer from inadequate prudential regulation and supervision and also macroeconomic instability. These are not sufficient reasons, however, to delay the onset of liberalization. On the contrary, this initial situation indicated the need to pay more attention to prudential regulation and supervision and to remedy deficiencies in this area. The maintenance of macroeconomic stability is seemingly more difficult to achieve but, as noted earlier, it cannot be considered a necessary requirement (however desirable) for financial liberalization in all countries. In fact, financial liberalization can be designed to ameliorate some of the adverse effects caused for the financial sector by macroeconomic instability.

^{1/} Despite these advantages, there could also be some pitfalls. For example, the crisis in savings and loan associations in the United States arose initially from the decontrol of deposit rates at a time when they were heavily concentrated in fix-rate mortgage loans. This factor, which wiped out the capital of these institutions, was aggravated by their subsequent entry into the real state business at a difficult time and with inadequate preparation. Finally, the crisis exploded as a result of careless supervision on the part of the savings and loans supervisory authority.

V. Some Concluding Lessons

There is no single recipe for the best timing and sequencing of financial sector reforms, as countries that embark in this undertaking are faced with different initial conditions, as political considerations influence the objectives of these reforms, and as practical and technical factors introduce ad hoc considerations. Depending on the initial conditions of the country and the objectives, some financial liberalizations can be accomplished successfully in a big-bang fashion, even if the supporting measures to strengthen prudential regulation and supervision and market competition cannot be fully operating from the start. Other liberalizations may require more time and thereby explicitly or implicitly raise the issue of the appropriate sequencing of the various elements of liberalization and the supporting measures. Unfortunately, in the area of sequencing the empirical studies are only beginning and analytical guides are inadequate. Much more research will be needed. Nevertheless, there are some basic principles which can guide the proper selection of the speed and sequencing of the reform measures.

One important principle seemingly valid for all cases is the need to accompany financial sector liberalization with the introduction and/or the enforcement of an adequate degree of prudential regulation and supervision. Otherwise, there is the risk that the efficiency gains from liberalization could be offset, at least partially, by adverse loan selection leading to a financial crisis in the form of unsound portfolios of financial institutions, which in turn could raise real interest rates to excessively high levels. However, prudential regulation and supervision over the financial sector cannot be a panacea as it can carry only part of the burden of ensuring sound banking practices. Consideration also needs to be given--especially in backward and emerging financial markets--to establishing procedures for imposing discipline through the development of markets and associated institutions.

Another important principle derived from experience is that, when liberalizing the financial sector, delays in addressing the problem of failing financial institutions and in eliminating the causes of the problem can be very costly in terms of both fiscal resources needed for the eventual rescue and the malfunctioning of the liberalized financial markets. This potential problem is closely linked with the required improvement in the performance of prudential regulation and supervision.

Macroeconomic stabilization--always a worthwhile objective in its own right--can also help substantially in alleviating the problems of transition to a liberal financial system and in maintaining the efficiency of the system once the liberalization has been completed. Nevertheless, for those countries that find it impossible to achieve stabilization in the short term, it is not always better to postpone financial liberalization. In fact, financial liberalization may be still desirable as a second-best, not only as a way of reducing the distortionary effects of inflation on a repressed financial system, but also as a way of signaling the need for the fiscal

sector to adjust in the face of having to bear the full cost of public sector borrowing through market-determined interest rates; part of this adjustment will take place in the course of the liberalization in the form of orchestrated reductions in the proportion of fiscal deficit financed through forced borrowing from the financial sector and a corresponding increase in the proportion financed in the private market. It is generally the case that the transition to a liberal financial system will have the temporary effect of increasing the rate of credit expansion above that of deposit creation, as market equilibrium is approached following the dismantling of direct credit controls, but there is no reason why the central bank cannot offset this expansionary effect through the use of newly created indirect instruments, including open-market sales and tighter rediscounts (one of the results of higher, market-determined interest rates following liberalization). There is of course a risk that real interest rates might have to be raised, temporarily, to very high levels to offset this credit expansion, with possible short-term costs on the economy. However, the long-term benefits of liberalization will likely dwarf these temporary adverse effects.

In addition to this transitory increase in liquidity, financial sector reforms may involve significant budgetary and real sector adjustment costs. Budgetary expenditures may increase due to the payment of market-related interest rates on government debt, and the use of budgetary funds to recapitalize troubled financial institutions. The reforms may impose real sector adjustment costs as interest rates and the exchange rate adjust, with adverse consequences for highly leveraged firms, some of which may be thrown into bankruptcy. These adjustment costs, although transitory and smaller than the long-term benefits in terms of improving savings mobilization and efficiency in the use of resources, will likely affect the political determination to carry out the reforms and, especially, the speed and sequencing of the measures, as the authorities will tend to compare the costs and benefits over time, and the latter may take longer to materialize.

Subject to the important caveats reflected in the above principles, progress can be made either rapidly or gradually as the circumstances of the country may dictate, but in any case a liberal financial system with the appropriate degree of prudential regulation and supervision is not something gained once and forever, as financial conditions may change. In fact, there can be reform reversals, most often following financial crises, as in the cases of the Southern Cone countries, which partly and temporarily re-controlled their financial sector (and some other sectors) following the liberalization effected in the mid-1970s. But even in these cases, the long-term path of the economy following financial liberalization shows the benefits in terms of both increased growth performance and the experience gained in conducting the proper macroeconomic policies in a liberalized environment. The more recent and sustained re-liberalizations in these and other countries attest to the ultimate success of liberalization efforts.

The variety of country experiences is so large that it has proven difficult to generalize about detailed features of the best sequencing of

financial sector reforms valid for all countries. Hence the lack of consensus in the literature, at least as of the time of this writing, about the existence of a unique optimal sequence of financial sector reforms valid for all countries. In designing the sequencing of financial reforms and stabilization, the issues have to be approached in a pragmatic way, and often tactical adjustments have to be made to seize opportunities that present themselves for moving the process along as quickly as possible.

Nevertheless, in addition to the above general principles, there are some common sense rules on sequencing that can help to avoid major policy errors (such as mutually inconsistent measures that hardly promote the financial sector objectives, and premature liberalization measures that crucially harm other objectives, e.g., macroeconomic stabilization) and to promote efficient implementation. As examples of inconsistent measures, it would generally not be appropriate to deregulate only some of the institutions of the financial sector, or to continue to control interest rates of financial institutions if the rates of government securities are free, or vice versa. ^{1/} As an example of premature reform measures, while the elimination of direct credit controls would be consistent with the final objectives of a liberal system, it should not be recommended until the alternative arrangements for proper monetary control under the liberal system are in place. These types of inappropriate sequencing can increase the risk of a financial crisis. Finally, there are structural linkages among specific reforms (for instance, monetary instruments and money market structure) that could dictate a specific sequencing of measures to ensure efficient implementation.

Because there are only a few general principles and rules for the appropriate sequencing of financial sector reforms, countries will need to search examples or some aspects of others' experience that best suits their needs. Pending further and much needed research in this area, it will be important to avoid controversial sequencing issues which often are used as excuses for delaying needed policy actions. The relative indeterminacy in sequencing should allow the authorities and their advisors ample room for maneuver. At the same time, technical assistance, such as that provided by the Fund and the World Bank, based as it is on a large variety of experiences of member countries, can guide the search for a unique path that is most suitable to the circumstances of a country, although it can never blindly copy the sequencing followed in any other country.

^{1/} However, these rules occasionally have been disregarded under some favorable circumstances in some countries without necessarily destroying the overall reform effort.

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