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The Speed of Financial Sector Reform: Risks and Strategies

by

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Abstract

This paper discusses some of the macroeconomic and microeconomic issues in the transition from a repressed to a market oriented financial system. Emphasizing the risks, the literature on the sequencing of reforms tends to place financial sector reform, and the opening of the capital account of the balance of payments, relatively late in the reform process. However, if account is also taken of the costs of delaying financial sector reform, a more rapid approach to financial sector reform could be desirable. The approach would require anticipating and preparing for the risks of a more rapid financial sector reform.

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I. Introduction

While the objectives and benefits of financial sector reform are well known, the approach to the transition from a repressed to a market oriented financial system continues to be debated. Emphasizing the risks of financial sector reform, the conventional, academic, view has tended to place financial sector reform relatively late in the overall sequence of reform and to favor a gradualist approach. 1/ However, there are also arguments for following a more rapid approach to financial sector reform as will be discussed in this paper. Gradualism normally involves waiting to see the outcome of the previous reforms before embarking on the next steps; more rapid approaches usually involve reforming a number of areas simultaneously.

The transition to a more market oriented financial system raises a number of issues for both macroeconomic and microeconomic policies. Critical macroeconomic questions in designing financial sector reforms are: what are the consequences of maintaining financial repression for economic performance--economic growth, inflation and the balance of payments; will it be possible to address poor economic performance, or to avoid the creation of inflation or balance of payments problems as part of a relatively rapid approach to financial sector reform; and will it be possible as part of this

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1/ The "conventional" approach suggests that fiscal adjustment should occur before financial sector liberalization and the elimination of controls on capital movements should occur after the domestic financial system is liberalized. See, for example, McKinnon (1991).

process to avoid serious overshooting in the level of interest rates and/or the exchange rate that could adversely affect the real sector? The main microeconomic concern relates to the capacity to address the weak institutional structure and market failures that are the legacy of prolonged financial repression and which could result in poor resource allocation and a possible banking crisis following the financial sector reforms.

This paper examines some of the macroeconomic and microeconomic issues that policy makers need to be aware of and to prepare for in the transition from a repressed to a market oriented financial system. An assessment of the costs of financial repression and the capacity to respond to the risks of liberalizing financial markets can determine what will be feasible or desirable in terms of the speed of the reforms. The argument for more rapid reforms is that there could be important benefits for investment and economic growth.

The paper is outlined as follows: Section II discusses monetary policy and section III the fiscal implications of financial sector reform; and section IV the question of the coordination of financial sector reforms with the opening of the capital account of the balance of payments. Section V discusses sources of institutional and market failures leading to microeconomic concerns with financial sector reform. Section VI reviews some considerations which would lead a country to follow a more rapid rather than a gradual approach to financial sector reform. Section VII provides some concluding remarks.

II. Monetary Control Issues

Many countries with repressed financial systems face problems of monetary control associated with the ineffectiveness of direct credit and interest rate controls. The problem with direct controls is not that the aggregates are uncontrollable, but because of circumvention and disintermediation, the controlled aggregates cease to bear a close relationship to the objectives of policy. The modification of monetary instruments in order to achieve more effective monetary control is an important motivation of financial sector reform, and the freeing of direct controls on interest rates and credit are central elements of most financial sector reforms.

Monetary control can be enhanced by increasing the reliance on indirect monetary instruments. These instruments include what are known as "open-market-type" operations such as auctions of treasury bills or auctions of central bank refinance credits/certificates of deposit to control money market liquidity. 1/ Such instruments can provide the flexibility of open market operations and a channel for the central bank to maintain monetary control during the initial phase of financial deregulation when markets are poorly developed.

1/ For a discussion of monetary control procedures and financial sector reforms, see Johnston and Brekk (1989).

Increasing the reliance on indirect monetary controls allows the authorities to eliminate the monetary regulatory distortions, including interest rate and credit controls, and a reliance on high non-interest bearing reserve requirements which increase deposit-lending margins. Open market type operations can also be catalytic in the development of domestic financial markets. It is, therefore, desirable to introduce these instruments very early in the financial sector reforms, and to increase reliance on them to achieve monetary objectives. 1/

The elimination of credit and interest controls has also potentially important effects on monetary and credit aggregates, which have to be taken into account as part of a successful transition. The liberalization of direct controls on credit and interest rates is likely to be followed by an initial shift in the holdings of money and credit aggregates, and a structural change in the interest elasticity of their demand. The liberalization of controls on bank credit is often associated with large increases in the stocks of gross financial assets and liabilities, and borrowing to hold larger money balances. A liberalization of bank interest rates may result in an initial rise in deposit rates relative to other rates of return and an increase in broad money holdings. Broad money may become less sensitive to changes in the general level of interest rates since interest rates on bank deposits would move in line with competing interest

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1/ Some countries temporarily maintain certain types of direct credit controls until the intended degree of monetary restraint has been achieved through indirect instruments. However, the maintenance of the direct control may result in continued resource misallocation.

rates. Because of these structural shifts, the information content of broad monetary and credit aggregates will become difficult to assess during the transition phase, and these aggregates will also become difficult to control through changes in interest rates.

The authorities would need to develop information systems to assess monetary conditions. Policy should be based on a review of a wider range of financial indicators--broad and narrow money, credit growth, inflation, etc. Given the potential shifts in asset demands, a greater focus may be given to targeting real interest rates or the exchange rate, or giving greater weight to these variables in the assessment of monetary conditions. However, the measurement of real interest rates creates a number of practical difficulties. 1/ Experience also suggests that the information content and the stability of demand for the currency issue is usually less affected than the broader monetary aggregates by financial sector reform. 2/ This could argue for setting the intermediate and operating targets at the level of the central bank's balance sheet rather than the banking system. 3/

1/ These difficulties include the measurement of inflation expectations, and the choice of the appropriate interest rate or price index and thus the real interest rate will vary depending on the agent involved, and the need to take tax rates into account.

2/ This reflects the fact that the supply of currency is not constrained under financial repression and is less affected by the elimination of controls on the banking system. The information content of currency is also less affected than other aggregates, see Hamann (1993).

3/ These issues and alternative approaches to monetary control that can be adopted during the period of financial sector reform are discussed in Johnston (1993).

The elimination of direct controls on credit is often associated with a period during which credit to the private sector expands more rapidly than private sector deposits, as banks run down holdings of excess reserves and lower remunerated public sector assets accumulated during the period of credit controls. The more rapid growth of credit than deposits reflects a stock adjustment in the credit supply which will be temporary where the countries maintain positive real interest rates. 1/ Nevertheless the credit expansion could result in a loss of macroeconomic control, adding to inflation or putting pressure on the balance of payments. However, to attempt to control the temporary credit expansion through interest rates and indirect monetary controls could result in a potentially large increase in interest rates and appreciate the exchange rate adversely affecting the real sector.

This raises the question as to whether the stock adjustment should be phased as part of a gradual approach to the elimination of the credit controls or accommodated, and if accommodated whether the potentially adverse macroeconomic effects can be avoided through a larger fiscal adjustment or simultaneous foreign inflows to protect the foreign exchange reserves. A phased approach could include allowing banks to increase credit only in response to increases in deposits. The credit controls should be supported by adjustments in interest rates and the indirect instruments of monetary policy. As discussed in subsequent sections, the scope for

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1/ For an analysis of country experience leading to these conclusions, see Bisat, Johnston, and Sundararajan (1992).

generating a sufficient fiscal adjustment as part of a more rapid reform strategy is likely to be limited by the impact of the financial reforms in increasing the measured fiscal deficit. Therefore, a rapid strategy could depend on the scope for generating simultaneous foreign inflows and this may in turn depend on the early elimination of controls on the capital account of the balance of payments that could help encourage a return of flight capital.

III. Fiscal Implications

Financial reforms make transparent the magnitude of the fiscal imbalance. Under financial repression, the actual fiscal burden is often hidden by the below market rates of interest on government debt--associated with compulsory purchases of debt by financial institutions--, the use of an appreciated exchange rate for official transactions, and the various quasi fiscal costs borne by the central bank through subsidized lending to priority and unprofitable sectors, and among commercial banks through the accumulation of loan losses on publicly sponsored but loss making projects. These "hidden" deficits still impose a financial burden on the economy which is no less great for the fact that they are not shown in the fiscal accounts. The costs to the economy of the hidden deficits include low savings mobilization, capital flight, and resource misallocation associated with credit rationing, directed credits, and an appreciated and uncompetitive official exchange rate. Countries experiencing significant hidden fiscal costs need to undertake fiscal adjustment.

Following the financial reforms, the measured budget deficit may be increased by:

-- the liberalization of interest rates on government debt instruments;

-- the transfer to the budget of the costs of subsidized lending, where this is allowed to continue;

-- the costs of restructuring the banking system, including possibly the central bank;

-- the application of unified exchange rates to official transactions (although tax revenue may also be boosted by the adoption of a more realistic exchange rate).

However, the capacity to finance the fiscal deficit can also be improved by the financial reforms because of the scope for developing markets in government debt instruments, and improved overall savings mobilization. The financial liberalization can also help impose discipline on fiscal policy as the newly emerging financial markets will send signals on the quality of fiscal policy and the need for fiscal action. Governments may, therefore, choose to deregulate financial markets--domestic and externally--in order to constrain their own future decisions. Financial sector reforms are also concerned with how resources are allocated and mobilized, and the benefits

in terms of efficiency of resource allocation will apply equally in the case of a large or small fiscal deficit.

Should financial sector reforms, therefore, be delayed by the size of the fiscal deficit as suggested by the sequencing literature? One reason suggested for delay is the potential loss of macroeconomic control. The risk is that without fiscal consolidation, the authorities would resort to money creation to cover the larger budget deficit. This comes back to the question of the ability to conduct monetary policy during the transition period and, therefore, the need to develop indirect monetary instruments including primary issue markets for government debt, and appropriate indicators to interpret monetary conditions. More generally, if the authorities are not committed to controlling the fiscal balance, the scope to maintain monetary control--whether by means of direct or indirect monetary controls--will be highly constrained. Therefore, appropriate fiscal policy will be an important component of any program of economic or financial sector reform. In the case of liberal financial systems,the perspective fiscal deficit will be a major factor determining longer-term rates of interest in the economy; under a repressed system the perspective fiscal deficit will be a major factor determining the continued degree of financial repression.

There is a second possible reason for delaying financial sector reforms until necessary fiscal adjustments have been implemented: if the authorities avoid monetizing the deficit and finance the deficit through market

instruments, domestic interest rates could rise to high real levels and the exchange rate appreciate, increasing the adjustment burden on the real sector. This is of particular concern where the deficit is large, financial markets are poorly developed and there is a lack of confidence in government policy. However, there are also counter arguments. First, lack of confidence in government policy is a reason why fiscal consolidation should accompany financial sector reform, but not necessarily for delaying the financial sector reforms until fiscal adjustment is completed. Second, the concern that underdeveloped financial markets may make it difficult to finance the increased deficit, does not appear warranted by experience, as countries have evidenced a good deal of success in developing primary issue markets very early in their financial sector reforms. Egypt's success in developing its treasury bill auctions is noteworthy in this regard. The initial underdevelopment of the capital market quite often reflects the unwillingness of the government to pay market interest rates on its debt in the first place. Third, as noted above, large fiscal deficits financed through financial repression impose resource costs and these have to be taken into account and offset against the cost of raising interest rates in a deregulated environment.

Fiscal policy may have other consequences for the effectiveness of financial sector reforms and vice-versa. For example, the tax deductibility of interest payments can blunt the effectiveness of interest rates as an instrument of monetary control; and the tax structure may provide unwarranted incentives to borrow through one instrument rather than another

or externally rather than domestically. Moreover, the loss of revenue from the reduction of high non-interest bearing reserve requirements on banks may require compensating tax reforms.

IV. Liberalization of the Capital Account

The liberalization of current external transactions including through reforms of exchange and trade controls, and the adoption of realistic unified, and frequently more market determined exchange rate arrangements early in the reform process is widely accepted as part of a strategy of economic and financial sector reform. Recently, there has been a greater focus on the complementary role of the liberalization of the capital account as part of the process of financial sector liberalization. The powerful effect that external financial liberalization can have in achieving a higher level of competition in the domestic financial system has been noted. 1/ Empirical research is also increasingly pointing to the ineffectiveness of controls on capital movements in protecting developing countries' balance of payments. 2/ The rationale for these countries maintaining such controls is therefore in question.

1/ See Guitián (1994).

2/ An examination of the impact of exchange controls on the private capital accounts of countries' balance of payments using cross country data for the period 1985-1992 indicated that these controls had no significant impact on developing countries' balance of payments; and there was some weak evidence that the elimination of exchange control actually improved the balance of payments. See Johnston and Ryan (1994).

There are a number of reasons why it may be desirable to undertake a more rapid liberalization of the capital account consistent with the reform of the domestic financial system:

-- because of the circumvention of controls and the existence of "black" foreign exchange markets, the degree of currency convertibility is already de facto high, and the maintenance of capital controls serves mainly to result in pronounced balance of payment statistical discrepancies. This complicates the interpretation of underlying economic trends, and obscures the interrelationship between domestic and external financial conditions;

-- freedom of international capital movements reinforces the policies to liberalize domestic interest rates and helps to create an environment conducive to the establishment of a competitive and efficient domestic financial system. The type of institutional reforms needed to create efficient money and foreign exchange markets can be mutually supporting;

-- capital account liberalization in the context of appropriate macroeconomic policies can effectively contribute to a return of capital flight, and support the balance of payments during the period of domestic financial liberalization. As already noted, the liberalization of the domestic financial system can result in a rapid credit expansion which would tend to weaken the balance of payments and increase the measured fiscal deficit. Sequencing the liberalization of the capital account to coincide with the domestic financial reforms, and the elimination of credit controls,

may be instrumental in a move aimed at achieving a more rapid lifting of credit ceilings. However, in order to generate such private inflows, it is important that the liberalization takes place against the background of reasonable confidence in government financial policies. If such confidence does not already exist, it would have to be created through accompanying fiscal consolidation.

There are, nevertheless, risks for the capital account from an inappropriate sequencing of reforms. A continued reliance on credit controls or high non-interest bearing reserve requirements for monetary control purposes, or a failure to address sufficiently inefficiencies in the domestic financial system, could result in wide spreads between deposit and lending rates and encourage borrowing abroad rather than domestically; in the event such developments could result in an overvalued exchange rate and excessive external debt burden. Surges in capital inflows have become a problem in some countries. 1/ Direct controls on credit and interest rates would be circumvented through the capital account. It would, therefore, be desirable to eliminate, as far as possible, the institutional and regulatory incentives to borrow abroad rather than domestically through an early reliance on indirect monetary controls and a strengthening of domestic financial institutions and markets as part of a strategy of simultaneous liberalization of the capital account and the domestic financial system.

1/ See Schadler, et. al. (1993).

V. Microeconomic Concerns

The major microeconomic concern with financial sector reform relates to the various sources of market failures or institutional weaknesses which are the legacy of prolonged financial repression and which would interfere with the efficient allocation of resources with the liberalization of the financial system. Market failures and resource misallocation are important problems of repressed financial systems. However, there is a risk that such developments will take different forms with financial liberalization, reducing the benefits for economic performance of the financial sector reforms.

Financial sector reforms, especially rapid reforms, have often been followed by financial crisis. 1/ Such crises have disrupted the financial sector, lead to a contraction of income, and resulted in a temporary reversal of the financial deepening and the reforms. The detailed examination of various financial crises indicates that the crisis can be traced to different country specific characteristics--including weak bank supervision, lending to interrelated entities and problems of moral hazard, and inappropriate macroeconomic policies which resulted in serious problems of exchange rate overvaluation and high real interest rates. Regardless of the specific cause of the crisis, the financial sector reforms quite often bring to fore structural weaknesses in the financial sector.

1/ See Bisat, Johnston and Sundararajan, ibid.

The major structural and institutional conditions which are often the result of prolonged financial repression and which result in resource misallocation and banking crisis following the financial reforms include:

(1) Insolvent banks: Banking solvency is quite often an issue at the commencement of financial sector reforms reflecting the weak capital bases, the poor loan portfolio and the inefficient management during financial repression. Insolvent banks have incentives to allocate credit to high risk/high return projects without due regard to the prospects for loan recovery in an attempt to regain losses with the liberalization of balance sheet controls.

(2) Inter-related ownership or incentive structures of banks and borrowers, associated, inter alia, with high concentrations of ownership and lending to a few large and interrelated enterprises and industries are also features of repressed financial systems involving credit rationing. Following financial reforms, the interrelations can result in increased lending to the interrelated enterprises, magnifying risk exposures and reducing the supply of credit to new borrowers;

(3) Inefficient financial institutions which do not have a commercial approach to banking that emerge because of the protection from competition under financial repression. Such institutions result in higher operating costs and lending margins and lower deposit mobilization and an inefficient allocation of credit;

(4) Unequal regulatory structures and particularly the existence of unregulated nonbanking institutions which have expanded as a result of direct controls on banks and which compete funds away from banks for high risk projects without due regard to prudential standards;

(5) Moral hazard, due to explicit or implicit public sector guarantees, including many deposit insurance schemes, resulting in insufficient attention by the public to the risks of different types of financial institutions. This is particularly a concern where such guarantees are viewed to extend to unregulated nonbanking institutions or where they are not supported by adequate prudential regulation of the banks. Moral hazard problems also arise where banks and borrowers have low net worth so that they have weaker incentives to internalize the consequences of their actions;

(6) Inadequate accounting and information systems, including internal controls within financial institutions which permit fraud and malpractice. The introduction of new freedoms to operate with financial reform can expose weaknesses in existing internal controls and audit and accounting procedures which have been targeted to meet alternative objectives in the repressed economy, e.g., monitoring compliance with direct credits and credit ceilings;

(7) Insufficiently diversified and developed financial markets, including foreign exchange markets, which have been discouraged/controlled

under financial repression. The absence of such markets results in excessive concentrations of risk in the banking system, and exposes borrowers to excessive interest rate risks or limitations on the access to funds;

(8) Legislative frameworks which are not tuned to enforce contracts and bankruptcy and thus financial discipline among borrowers;

(9) Inadequate institutional capacities, knowledge and skills including among the central banks to implement monetary control and appropriate supervision and regulation in a deregulated environment, and among financial institutions to assess and control risks;

(10) Poorly developed payment systems providing limited incentives for efficient monetary management and, therefore, blunting the importance of interest rates in allocating resources; 1/ and

(11) Rapid credit expansion in the wake of financial liberalization which can strain credit approval procedures and result in increased lending to more risky projects.

These weaknesses need to be dealt with as part of the market orientation of the economy. In some countries, financial crisis may indeed

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1/ The importance of payments system reform as part of financial sector reforms is discussed in Baliño, Dhawan, and Sundararajan (1994).

have been necessary to promote a consensus on the need for action on restructuring the banking system that was sufficient to over turn entrenched vested interests. However, such an approach is likely to be less than optimal given the potential disruptive effect of a banking crisis and the risk that it will result in a reversal of financial sector reforms. A minimal system of bank supervision and regulation, and capacity for implementation, which can help reduce the risk of financial crises as well as improve credit allocation processes, are important, if not critical, when embarking on financial sector reforms. Experience with banking crises suggests that the immediate focus should be on capital adequacy, lending to interrelated entities, large loan concentrations, loan classification and provisioning procedures, moral hazard, and creating a capacity to conduct bank supervision both off and on site. 1/ Concerning the unregulated nonbanking institutions, the best approach may be to allow those institutions which are insolvent to fail, and to require the solvent institutions to meet minimum prudential standards in the context of moving toward a more level playing field for the regulation of financial transactions.

Technical assistance by national and international agencies on institution building can also assist the national authorities' efforts in addressing some of the structural and institutional weaknesses that result

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1/ Johnston (1991).

in resource misallocation. 1/ This assistance is provided at a number of levels: diagnostic and technical assistance missions; assignment of experts for hands on assistance; staff training; and grants and loans for the acquisition of equipment and hardware to upgrade the financial system. The IMF assistance on the financial system has focused on designing the monetary, exchange and payment systems; developing the appropriate legal and regulatory arrangements including central bank, commercial bank and foreign exchange laws; and building the institutional capacity of the central banks including those in monetary and exchange operations, bank supervisory functions and payments systems. The IMF also works closely with other agencies to coordinate technical assistance in financial sector reform. 2/

VI. Considerations in Choosing Between Rapid and Gradual Liberalizations

Given that there are costs and risks of financial liberalization and maintaining financial repression, what considerations might lead a country to follow a rapid or more gradual approach to financial reform? First, there is the question of whether the country can "afford" a gradualist approach which might involve retaining elements of financial repression perhaps for a prolonged period of time. The objective of financial reform is to improve the mobilization of financial resources and achieve greater

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1/ The IMF, World Bank and national agencies, including USAID, are important providers of technical assistance in the area of financial sector reform.

2/ See Zulu (1994) for a discussion of the IMF's Monetary and Exchange Affairs Department role in providing and coordinating technical assistance in the area of financial sector reform.

efficiency in their allocation. To postpone financial reform involves a potential cost for economic growth. Typically, more gradualist approaches to reform have been followed in countries with high savings ratios--Japan and Korea for example. These countries probably could in some sense "afford" gradualism since efficient financial systems were not critical to domestic savings mobilization and these countries could achieve high rates of growth even with some marginal inefficiency in resource mobilization and allocation. More rapid financial liberalizations have been adopted by countries as part of growth oriented strategies in the context of low domestic saving ratios--such as some of the South American countries. The objectives of these reforms are both to increase savings mobilization and to allocate it more efficiently.

Second, is the question of the "de facto" nature of the economy as opposed to the official economy. Parallel, market oriented, financial institutions and markets evolve in most highly regulated economies. Direct credit and interest rate controls result in disintermediation and the growth of curb markets; exchange controls are circumvented via various channels including under and overinvoicing of foreign trade transactions. When the incentives are large and prolonged, the official sector of the economy may come to represent only a fraction of the total economic activity. Such an outcome is quite often observed in war torn economies, or countries which have gone through major political upheavals. In designing the appropriate strategy for reform, national authorities should recognize the de facto nature of the economy, since such a recognition could be crucial in

regaining macroeconomic control. A move in this direction will often require eliminating rapidly the constraints on the official sector and relying on markets and indirect controls which affect the formal and informal sectors more equally.

Third, there are questions of political economy. In some cases rapid financial liberalizations have been used as the catalyst to broader economic reform and as a way of overcoming inertia in certain parts of the economy, such as the labor market. It is usually politically easier to start reforms in the financial sector rather than other areas. More rapid approaches to reform may be needed to overcome entrenched vested interests. Moreover, rapid reforms can add credibility to the Government's commitment to carry out reforms and help the mobilization of external resources. This credibility comes in the form both of the tangible evidence that the authorities are moving ahead with reforms and from the evident increased willingness of the Government to subject itself to discipline from markets. Some of these factors were important in New Zealand's decision to liberalize both its domestic financial system and external transactions rapidly in 1984/85.

Fourth, financial sector reforms are often undertaken in the context of complex economic and political circumstances. In many cases the reforms are part of programs of macroeconomic stabilization, and frequently an essential part of programs, precisely because of the failure of the repressed financial system to deliver adequate economic performance. These countries

may not have the luxury of stabilizing or of creating the desirable institutional preconditions prior to embarking on financial sector reform; these have to be created during the reforms. It is also debatable whether rapid or gradual approaches to reform impose larger burdens of implementation on the policy makers. The strategies and approaches to financial sector reform must take these factors into account if they are to be relevant in a large number of developing countries.

VII. Concluding Remarks

The literature on sequencing has tended to place financial sector reforms relatively late in the overall sequencing of reforms and favored a gradualist approach. However, if account is taken of the costs of maintaining the controls on the financial sector--in terms of low savings mobilization, capital flight, lack of monetary control, and an inefficient allocation of resources--, and if the major risks of financial sector reform can be anticipated and prepared for, then a strategy of more rapid financial sector reform could be desirable in terms of achieving better economic performance.

A more rapid strategy could involve an early adoption of market based monetary controls, simultaneous liberalizations of the domestic financial system and the capital account of the balance of payments, and concurrent fiscal consolidation and strengthening of financial institutions and markets.

-- Key monetary control reforms, including the introduction of indirect controls such as "open market type" operations, should be initiated early in the reform process. Such a requirement reflects the critical objectives of achieving and maintaining monetary control while allowing for the removal of the various discriminatory controls on interest rates, credit, and financial institutions' portfolios;

-- With the elimination of domestic financial distortions, the simultaneous liberalization of the controls on capital movements could help support the domestic financial sector reforms by increasing competition and by encouraging a return of flight capital;

-- Concurrent fiscal adjustment would be essential for credibility, and to reduce pressure on market interest rates and to support monetary policy in the deregulated environment;

-- Institution building, regulatory reform, and a minimum system of prudential regulation would be critical in order to address market failures, potential financial instability, and the regulatory or institutional incentives to borrow aborad which may accompany the financial deregulation.

Lack of a credible fiscal policy and failure to address banking sector problems would risk a costly reversal of the reforms.

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