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Financial System Design, Pace and Sequencing of Reforms**

by

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Strategic Decisions for Financial Systems in Transition: Financial System Design, Pace and Sequencing of Reforms

Alexandr Akimov and Brian Dollery **

Abstract

In the aftermath of the collapse of communism in Eastern Europe, transition economies faced acute problems in transforming their economic institutions to be compatible with a market economy, including the financial sector. This paper explores some of the major problems involved in this transformation process posed by re-structuring of financial system and the pace and sequencing of financial reform. The paper considers bank-dominated and market-oriented financial system design; ‘shock-therapy’ as against ‘gradualism’ in reform; the scope of financial sector reforms and liberalisation; and the optimum sequencing of financial sector liberalisation.

Key Words: Financial reform; post-communist countries; transition

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INTRODUCTION

The structure of financial system, the pace and sequencing of reforms for transition economies have been the subject of heated debates among economists over the past decade. After the collapse of socialism in the Eastern Europe, the economies of post-communist countries were in urgent need of market-orientated reform. Policymakers in these countries thus had to make tough decisions regarding the design of the financial system, the speed with which market-oriented reforms should be implemented, as well as the sequencing of these reforms. A majority of Central and Eastern European countries and some former Soviet republics have already implemented many of these reform measures. However, there are still some countries from the former Soviet Union that still must take some or all of those decisions. This paper thus presents theoretical considerations and empirical evidence underlying the basis for decisions of this kind.

The paper itself consists of five main sections. Section 2 considers the choice between bank-dominated and market-oriented financial system design in transition economies. Section 3 examines the two main approaches to reform - 'shock-therapy' and 'gradualism'. Section 4 deals with the application of the theory of political economy reform to transition countries. Section 5 considers the scope of financial sector reforms and liberalisation and assesses the theory of the optimum sequencing of financial sector liberalisation from the point of view of transition economies. The paper ends with some brief concluding remarks in section 6.

A MARKET-ORIENTED OR A BANK-DOMINATED FINANCIAL SYSTEM?

One of the important decisions countries in transition have to face is what kind of financial system to adopt. Put differently, these countries must consider whether to try to imitate one of the existing models used in the OECD countries, or attempt to design a new system, which better fits their own requirements. If the first option is followed, then there are a number of different alternative models, ranging from a 'bank-dominated' system (i.e. Germany or Japan) to a 'market-oriented' (i.e. Anglo-American) system.

In transition economies, it is often argued that the costs of trial and error in gradually developing a financial system might be overcome through the careful design of a financial system appropriate to the circumstances of the country in question. In this sense, the manner in which banks and stock markets can enhance economic development form a useful basis for decision-making. In broad terms, economic theory suggests that both capital markets and banks can encourage economic growth by fulfilling several of the functions of a financial system.

For capital markets, the most important transmission channel is their creation of liquidity. Liquid capital markets reduce investment risk and open up opportunities for diversification by investors. This is accompanied by enhanced access to finance for firms. Furthermore, financial markets stimulate information acquisition and help improve corporate governance, by allowing takeovers for example (Shleifer and Vishny 1997). Finally, capital markets can contribute in fulfilling other functions of

the financial system, such as efficient resource allocation, the mobilisation of savings and the facilitation exchange.

The comparative advantage of bank finance lies in establishing long-term lender-borrower relationships between lenders and borrowers since banks usually have better access to comprehensive information about firms. Over time, the cost of acquiring such information becomes lower (i.e. it effectively becomes a variable cost) (Steinherr and Huveneers 1994). Moreover, banks yield additional insights by providing complementary financial services, such as market research, the issuance and placement of securities, overall financial advice and participation in boards of directors. Savers benefit from banks being able to offer the simultaneous benefits of risk diversification and liquidity. Banks are thus crucial in mobilising savings from populations through the use of their extensive branch networks and allocating resources into longer-term projects.

In sum, it can be argued that both banks and capital markets encourage economic growth by fulfilling the functions of an efficacious financial system. However, there are opponents of the view that stock markets are important for the process of long-term economic growth. For instance, Singh (1997) is well-known for his theoretical argument that stock markets do not perform the monitoring, screening and disciplinary role effectively. Moreover, he advanced three reasons in support of the proposition that stock markets are unlikely to help in achieving industrialisation and economic growth in developing countries. In the first place, stock markets are poor guides for efficient investment allocation in the developing countries due to their

inherent volatility and the arbitrariness of the pricing process. Secondly, in the wake of unfavourable economic shocks, the interactions between the stock and currency markets may aggravate macroeconomic instability and hamper economic growth. Thirdly, stock markets may undermine ‘group-banking’ systems in developing countries, which proved to have had merit in several cases.

There is also an extensive empirical discussion on whether or not capital markets enhance economic growth. However, no comparable debate over the role of banks exists. For example, Levine and Zervos (1998) examined empirically whether banking and stock market indicators were robustly correlated with current and future economic growth rates, capital accumulation, productivity growth and capital accumulation using data on 47 countries from 1976 through 1993. They found that ‘stock market liquidity - as measured by the value of stock trading relative to the size of the market and by the value of trading relative to the size of economy – was positively and significantly correlated with current and future rates of economic growth, capital accumulation and productivity growth. Moreover, ‘the level of banking development – as measured by bank loans to private enterprises divided by GDP – also entered these regressions significantly’ (Levine and Zervos 1998: 538). Furthermore, they did not find any indication for a negative impact of stock price volatility or capital market integration on economic growth.

Atje and Jovanovic (1993) also found strong support for a positive role of stock markets in promoting economic growth were Their study concluded that stock market trading and economic growth were strongly correlated for a group of 40

countries in the 1980s. In addition, in his review of recent literature, Scholtens (2000: 529) concluded that ‘... there is no empirical evidence that one type of financial architecture is superior to the other’.

However, Singh (1997) questioned the methodology used in the (then) most recent studies on stock market development and economic growth. He contended that Barro-type reduced form growth regressions, used in most studies, did not yield any insights into the way in which stock markets influence economic growth. Steinherr and Huveneers (1994) in their tests could not reject the assumption that universal banking might provide superior long-term economic strategies for non-financial firms than capital markets. More recently, Arestis *et al.* (2001: 37) empirically analysed six developed countries and concluded that ‘...while stock markets may be able to contribute to long-term output growth, their influence is, at best, a small fraction of that of the banking system’. These findings were consistent with the view that bank-dominated financial systems could be better in promoting long-term growth than market-based ones.

A critical issue in the transformation of a financial system is its condition prior to transition. In contrast to textbooks, real-world economies cannot simply assume a ‘clean slate’. Blommestein and Spencer (1994) analysed the reform of financial system in transition economies. They found that financial systems inherited from a central planning system were totally inadequate. Banking systems were plagued by insufficient capital funds, severe problems of non-performing loans (to state enterprises), geographic and sectoral concentration of loans, small branch

networks other than for savings banks, inexperienced staff and poor management. The equity and bond markets were either non-existent or extremely small and illiquid. Furthermore, many banks were highly specialised, and despite the increasing number of banks, competition among them was very limited.

On basis of analysis of the economic environment of post-communist economies at the beginning of the transition process, economists generally supported the idea that an efficient banking system was a prerequisite for an efficient stock market. For example, Steinherr (1993: 1049) argued that ‘at a low level of development at least, the banking versus markets debate misses the point. There are no alternatives: Banking needs to precede markets’. His arguments were based on the view that ‘... for efficiency, securities markets require highly stable political institutions, a sophisticated legal system and commitment to market economies, they can only be observed in a few of the most developed societies’ (Steinherr 1993: 1055). Moreover, Mayer (1990: 326) supported the superiority of banks over markets: ‘...[T]he implication of both the empirical observation of a preponderance of external finance coming from banks and control models of corporate finance is that banks may be superior to the market in promoting economic development and growth’. Scholtens (2000) also suggested that transition economies should encourage a safe and sound banking system prior to the development of the stock market. However, he contended that capital markets needed to be developed very quickly as well since they were regarded as complements rather than substitutes to the banking sector. Nevertheless, ‘...a prerequisite seems to be that the regulatory infrastructure is

well-developed and that measures are taken to reduce extreme volatility of stock prices' (Hermes and Lensink 2000: 513).

A summary of the relevant literature is provided in the Table 1.

Table 1: The importance of financial structure for economic development

Author (s)	Method	Data	Findings
Mayer (1990)	Empirical	Eight developed countries	Banks may be superior to the market in promoting economic development and growth
Atje and Jovanovic (1993)	Empirical	40 countries in the 1980s	Support positive role of stock markets in promoting economic growth
Steinherr (1993)	Theoretical	Not applicable	At low level of development, banks need to precede markets
Szego (1993)	Theoretical	Not applicable	Transition economy should create its own financial system, which better fits its unique needs and constraints
Blommestein and Spencer (1994)	Theoretical	Not applicable	Efficient banking system is prerequisite for an efficient stock market
Steinherr and Huveneers (1994)	Empirical	A number of developed countries	Could not reject assumption that universal banking might be a superior foundation for long-term economic term strategies of non-financial firms than capital markets
Demircuc-Kunt and Levine (1996)	Theoretical	Not applicable	Well-developed stock markets can help align the interests of owners and managers and thereby spur efficient resource allocation and economic growth
Shleifer and Vishny (1997)	Theoretical	Not applicable	Capital markets contribute in fulfilling functions of financial system by stimulating information acquisition and helping to improve corporate governance
Singh (1997)	Empirical	Various developing countries	Financial liberalisation is unlikely to help in achieving quicker industrialization and faster long-term economic growth in most developing countries
Levine and Zervos (1998)	Empirical	47 countries from 1976 through 1993	Stock market liquidity is positively and significantly correlated with current and future rates of economic growth, capital accumulation and productivity growth. Moreover, the level of banking development also enters these regressions significantly
Scholtens (2000)	Literature review	Not applicable	No empirical evidence that one type of financial architecture is superior to the other
Arestis, Demetriades and Luintel (2001)	Empirical	Six developed countries	While stock markets may be able to contribute to long-term output growth, their influence is, at best, a small fraction of that of the banking system
Bergloff and Bolton (2002)	Empirical	Central and Eastern European countries and former CIS	In the more successful countries of Central and Eastern Europe, financial architecture appears to have converged to a bank-based system with substantial foreign ownership.

While policymakers obviously must make their own judgements for each transition economy, it is nonetheless useful to assess advantages and disadvantages of each type of system in general (Mayer 1990).

The market-oriented system seems to possess the following major advantages:

- It emphasises a more direct relation between the saving population and investing firms;
- The development of the financial markets implies the creation of new institutions so that the break with the institutions of the previous era will be more profound; and
- The creation of competitive conditions in the securities market should enhance economic efficiency.

The main disadvantages of the market-oriented system appear to be:

- Direct finance requires a more active portfolio choice, which is relatively costly for small savers;
- Firms financed through the widespread sales of securities may have passive shareholders which can lead to serious agency problems where managers pursue their own goals and do not maximise firm value; and
- Securities-based financing relies on well-developed corporation law and securities regulation, which are difficult to develop quickly in the context of transition economies.

By contrast, the major advantages of the bank-dominated system seem to be:

- It builds on existing institutions;
- Banks are better at collecting information and monitoring the execution of projects; and
- Firms face a smaller number of creditors with whom to deal.

However, the main disadvantages of the bank-dominated system are:

- Since the banking sector typically emerged from a 'monobank' in most transition economies, there will be a tendency for banks to be dominated by the government; and
- Banks may be influenced by a variety of pressures from the central bank or other bank regulators.

In reality, no capitalist financial system is based purely on either banks or capital markets. Moreover, there is no doubt that no financial system can exist without banks. Indeed, experience shows that a modern financial sector requires at least a liquid government securities market. Accordingly, the choice lies between the two models. Undoubtedly, each transition economy should create its own financial system, which better fits its unique needs and constraints. The design of the system should consider both the advantages and disadvantages of traditional models as well as alternative models (see, for example, Szego 1993).

In assessing the choices of transition countries after more than a decade since the onset of the process of change, most countries have selected the bank-dominated

system (Berglof and Bolton 2002). The only significant exception may be the Russian Federation, which seems to be drifting in the direction of a market-based system. Popov (1999) provided an explanation for this phenomenon. He contended that financial system design in transition economies is not a matter of deliberate choice by policy makers based on advantages or disadvantages of each particular model. Instead, it is the result of path dependent development with an outcome determined primarily by two factors: The chosen model of privatisation and the degree of concentration of the banking system. He argued further that because Russia selected the model of privatisation, which favoured the development of securities markets (through voucher methods and 'give away' properties to employees rather than direct sales of property to the highest bidder), in addition to the weakness and low degree of concentration of the Russian banking sector, it had moved towards a market-based system. By contrast, other transition economies have chosen either a method of privatisation unfavourable to development of a securities market or possessed a higher initial degree of concentration of the banking sector, or both.

Although the choice in favour of a bank-dominated financial system in transition economies (whether deliberate or not) seems to be obvious at least in short to medium-term, it by no means guarantees success in building an efficient financial system (Fries and Taci 2002). Institutional infrastructure (i.e. the monetary, fiscal and regulatory environment) plays significant role in facilitating financial development (Berglof and Bolton 2002).

SHOCK-THERAPY VERSUS GRADUALISM

Once a principal decision on financial system design is made, the issue of the pace of implementing financial system reforms arises. The answer to this question is interrelated with broader issue of the pace of economic reforms.

Most transition economies have chosen a gradual approach to economic reform. However, notable exceptions include Poland, the Russian Federation, and (for a short period) Czechoslovakia, Bulgaria, Estonia and Latvia. Their approach was termed the ‘shock-therapy’ or the ‘big bang’ approach and focused on the introduction of radical reforms in those areas where it was actually possible to implement drastic reforms. These reforms included macroeconomic restraint, price liberalisation and trade liberalisation (see, for instance, Allsopp and Kierzkowski 1997).

The shock-therapy model of transition was attractive to transition governments and international financial institutions due to its simplicity and the relatively narrow range of transition policies it required. A common argument was to ‘get the prices right’ and the remaining elements of a capitalist market system would follow. According to the shock-therapy model, restructuring could not have taken place without an effective price system, and an effective price system could not have existed without a convertible currency. In turn, a convertible currency would not have been possible without international competition, and international competition would not have been effective without restructuring (Marangos 2003). Shock therapists argued that maintaining distorted prices and entry barriers would only encourage

speculation, the misallocation of national resources and corruption. In the financial sector, it was argued that 'bad money drives out good money: so long as the old political connections remain intact, there is strong inertia in favour of vested interests; and so long as the bureaucracy still plays a major role in credit allocation, it is difficult for commercial banks and market forces to gain a foothold' (Hawtrey 1996: 198).

Opponents of shock-therapy, often referred to as 'gradualists', argued that shock-therapy could lead to economic instability and unpredictability. Instability could create excessive hardship, unemployment and a loss of markets (Hawtrey 1996). According to gradualists, instead of a 'sink or swim' strategy of liberalisation first, and marketization later, liberalisation should proceed in a sequence and at a pace that paralleled the actual evolution of market institutions and processes. This would include, among other things, the enforcement of money contracts, accountability by managers of publicly-owned firms for results and performance remuneration, and most importantly, the emergence of 'market-makers', like wholesalers, bankers, and infrastructure and communication services (Elliot 1995). Until these market-oriented requisites were in place, there would be 'no need for the full scale privatisation of productive assets, freeing prices and incomes, introducing full scale convertibility, and establishing stock and foreign exchanges' (Kregel *et al.* 1992: 121-122).

There were also scholars who did not accept that the choice of a strategy played an important role for economic performance. Popov (2000), for example, noted that economists debated excessively over which strategy to choose (i.e. shock-

therapy or gradualism) and thus missed the crucial point of the strength of institutions. He argued that the choice of model would be a much less significant issue for achievement of good economic growth. What important is the strength of institutions at the beginning of transition. The difference in institutional capacity thus predetermined a different performance in different transition countries.

Most of the above-mentioned arguments were based on purely economic considerations, ignored political constraints, and were prescriptive in style. Moreover, so-called 'political motives' were often used to explain why practice often diverged from prescription. Rodrik (1993: 356) maintained that 'economists have always been better at telling policymakers what to do than at explaining why policymakers do what they do'. Nevertheless, a number of economists appreciated the importance of politics during the transition process and attempted to explore political economy arguments. For example, shock therapists argued that the speed of reforms was crucial because 'a window of political opportunity' was created by the establishment of democracy. Policy makers should use this opportunity to implement reforms as soon as possible (see, for example, Balcerowicz 1995; Lipton and Sachs 1990) and attempt to create irreversibility for these reforms (see, for instance, Boycko *et al.* 1995). The political economy case made by gradualists was that an appropriate sequencing of reforms would provide demonstrated successes to build upon, thus creating constituencies for further reforms (see, for example, Dewatripont and Roland 1992a, 1992b, 1995; Litwack and Qian 1998; McMillan and Naughton 1992; Wei 1997). In China, the success of de-collectivisation ensured support for further

reforms. Similarly, it was thought that in Eastern Europe, the development of small and medium business would provide the support necessary to restructure the state sector.

Political economy arguments have also been used to explain the contrast in the performance of various transition countries. Although all transition economies experienced a fall in output at the beginning of the transition process, some of them (mostly Eastern and South European countries) recovered much more rapidly than their counterparts in the Commonwealth of Independent States (CIS). A political economy argument that often has been used to explain this phenomenon was that rent-seeking and state control were much more important in the latter countries (European Bank of Reconstruction and Development 2000; Hellman and Shankerman 2000). A second argument was that those countries that hoped for accession into the European Union (EU) had additional incentives to reform their economies and judicial systems to comply with the EU requirements (Roland 1997; Roland and Verdier 1999). The importance of political constraints in the transition process has led to development of a broad theory political economy of reform. Thus this theory of the political economy of transition belongs to a more fundamental branch of economics that aims to integrate political variables into the analysis of economic problems (Roland 2002).

THEORY OF POLITICAL ECONOMY OF REFORM IN TRANSITION COUNTRIES

The theory on the political economy of reform divides into two broad areas: normative and positive analysis. The normative theory concentrates on the decision-making process by policy-makers subject to political constraints. Models of normative political economy are usually based on the so-called 'agenda-setting hypothesis'. This hypothesis assumes that executive authority is responsible for the design and sequencing of reforms. This reform package would be offered for assessment and vote in a legislative authority or in public elections (McKelvey 1976; Romer and Rosenthal 1979). Since these models do not assume amendments to reform programmes, such reform package can be viewed as an 'accept-or-reject' offer made to voters.

In contrast to the normative political economy of reform, the focus of the positive political economy of reform does not centre on policy recommendations but rather on trying to understand the balance of power across countries and across time (Roland 2002). Less scholarly effort has been directed at the positive analysis of reform than at the normative analysis of reform in the transition context. The focus of this article will thus be on the normative political economy of transition.

Roland (1994) identified two types of political constraints. Those constraints that can prevent reforms from being accepted and decisions being made represent *ex ante* constraints. The second set of constraints that can reverse reforms after implementation and known outcomes are *ex post* political constraints. Roland (2000)

further argued that each type of constraint should be dealt with differently. To overcome *ex ante* political constraints, compromises must be found on reform plans or compensation must be provided to those who would lose from reforms. If this is not done, then decisions on the political programmes must be delayed. To prevail over *ex post* constraints, policymakers should try to create irreversible reforms.

In a perfect world, *ex ante* and *ex post* political constraints would be identical. However, in the real-world they differ due to uncertainty and reform reversal costs. In the presence of uncertainty, particular reforms might not be accepted even though the same reforms would bring benefits to the majority and not be reversed if implemented. This point was first advanced by Fernandez and Rodrik (1991) in the framework of a trade liberalisation model. Roland (2000) expressed this argument in terms of a simple general model. Let the discount rate be d with an assumption of an infinite time horizon. Individuals face a reform with probability p of gaining from the reform with net present value (NPV) of $g > 0$. The probability of losing from the reform is $1-p$ and NPV of their loss is $l < 0$. With a large population, p is also the number of *ex post* winners from the reform. Pay off from the *status quo* is assumed to be 0 . At time $t=0$, voters decide to accept or reject reform. At time $t=1$, they also decide whether to reverse reform or not, if it was accepted at $t=0$. In case of reversal, there is a cost incurred equal to c . If it is assumed that $l > c$, losers will always prefer to reverse the reform.

If $p > 1/2$, a majority will always prefer reform *ex post* and block the reversal of reform. If $pg + (1-p)l < 0$, and assuming risk-neutrality, then reform will be rejected *ex-ante* by all. Furthermore, since everyone knows that the reform will not be reversed once accepted, it will not be accepted when the expected pay-off is negative, even though a majority will be winners *ex post*.

If $p < 1/2$, a majority will support the reform *ex post* and block any attempts to reverse it. Even if $pg + (1-p)l > 0$, but the reversal costs are higher than pay off (i.e. $c > pg + (1-p)l$), then the reform package will not be adopted. Furthermore, people know that reform will be reversed by a majority *ex post* anyway. Thus, the net pay-off from accepting reform will be less than *status quo* of 0. For reform to be implemented and not reversed, both *ex ante* and *ex post* political constraints must be overcome. If this is not the case, then reforms will not be adopted. This phenomenon was termed by Fernandez and Rodrik (1991) a *status quo* bias against reforms. The major finding of this model is that the resilience of a reform process is determined by uncertainty resolution over time. It is thus important to note that optimal sequencing of reforms is a property of the uncertainty resolution to shift majorities over time.

Uncertainty and reversal costs often work simultaneously. This is particularly true if there is aggregate uncertainty about the outcomes (Roland 2002). Individual uncertainty arises when it is unclear who are the winners and losers from a particular reform. Aggregate uncertainty is the uncertainty of the overall country-wide effect of the reform program. The type of uncertainty plays an important role when comparing

shock-therapy and gradual reform strategies. Roland (2000) argues that under aggregate uncertainty a gradual strategy can overcome the *status quo* bias because of its flexibility and experimentation value. This is in contrast to purely individual uncertainty, such as in the Fernandez and Rodrik (1991) model, where a shock-therapy approach is always preferred to a gradual strategy. In this case, the gradual approach fails not only to overcome the *status quo* bias, but it also creates an additional *status quo* bias, termed the interim *status quo* bias, whereby vested interest can impede the implementation of reforms.

In order to demonstrate this proposition, Roland (2000) modelled a reform package under aggregate uncertainty. He found that a gradual strategy had the following advantages over a shock-therapy approach: (i) It is easier to initiate the gradualist reform programme earlier (i.e. a timing advantage); (ii) it has a lower reversal cost if reform brings negative outcomes; and (iii) it results in welfare maximisation. In contrast, the shock-therapy strategy is a better option if it is necessary to create irreversibility of reforms. Furthermore, it might facilitate achieving faster reform outcomes when required (i.e. in time of crisis). In sum, Roland (2000) argued that there is a trade-off between the shock-therapy and gradualist approaches. Gradualism has a higher *ex ante* acceptability, but a lower *ex post* irreversibility than shock-therapy. However, it is important to note here that more irreversibility cannot always be seen to be advantageous. Privatisation in Russia provided a conspicuous example. Former government officials claimed that privatisation, despite its economic failure, was a political success since it was not

reversed. However, one could question the success of such reform in terms of its welfare consequences.

The complementarity between reforms and reform momentum is critical to the debate. A transition process involves a set of reforms, some of which play a complementary role to others. Shock-therapy advocates adopt complementarities in support of their arguments. Nevertheless, the complementarity of reforms does not prevent gradualist strategies from being potentially optimal (Roland 2000). The main reason is that the initial loss associated with partial reform due to complementarity may be outweighed by the informational content of outcomes of the partial reform. Moreover, Roland (2000) concluded that ‘complementarity of reforms can be a necessary condition for gradualism to be optimal’. He pointed out that some scholars, such as Hellman (1998), could not support the optimality of gradualist strategy because they had assumed separable and not complementary, reforms.

The prospect of accession to the European Union has been an important trigger for reform momentum in Eastern and Central European countries. It was clear that both a market economy and democracy were necessary pre-conditions for European Union entry. Combined with a general discontent at being part of the former Soviet bloc, Eastern and Central European countries employed effective timing for comprehensive reforms. A good example of a reform momentum under the gradualist strategy would be the dual-track price liberalisation program in China. The success of de-collectivisation provided necessary public support for further reforms, like price liberalisation and public enterprise reform. The momentum effect created

by the initial reform under a gradualist strategy raises important questions about the optimal sequencing of reforms: Put differently, with which particular reform should an overall reform strategy begin?

OPTIMAL SEQUENCING OF FINANCIAL SECTOR REFORMS

Under conditions where gradualism is the preferred option over shock-therapy, the sequencing of reforms is crucial to ensuring the soundness and quality of gradualist programs. Roland (2000) identified three critical steps for the ‘correct’ sequencing of reforms: (i) The reform package should be unbundled so that it would not lose the property of ‘informativeness’; (ii) sequencing should be designed to be acceptable *ex ante*; and (iii) sequencing should be constructed to aim at building reform momentum for further reforms and satisfying *ex post* political constraints. He modelled the sequencing of two reforms under three different conditions: (i) Sequencing of reforms with differences in expected outcome; (ii) sequencing with differences in riskiness; and (iii) sequencing of reforms with differences in constituencies. Roland (2000) concluded that there might be a potential trade-off between *ex ante* acceptability and *ex post* irreversibility when one yields a positive option value of early reversal whereas the other does not. This trade-off is similar to the trade-off between gradualism and shock-therapy when the first is optimal from *ex ante* point of view. However, this trade-off does not always exist and *ex post* irreversibility can actually increase acceptability when one sequencing method involves interim *status quo* bias whereas the other programme does not, while still having an option value of early

reversal. The general principle for optimal sequencing is to design reform in such a way as to shift pivotal voters or decision-makers towards continuation of reforms in the interim stages.

Since the beginning of the transition process in the former communist bloc, numerous economists have presented policy advice to the governments of transition countries. Representatives of international financial institutions (like the International Monetary Fund, the World Bank and others) have been deeply involved. In a majority of cases, they advocated a shock-therapy approach. However, the institutional and other peculiarities of a transition process were largely ignored. In general, policy advisors emphasized the positive aspects of speedy transition and minimised potential risks. This tended to generate a shock-therapy bias in the early literature on transition. More recent literature has been much more nuanced (see, for example, Elliot 1995; Litwack and Qian 1998). It has provided a better understanding of the range of policy options; in particular, where a model may be preferable depending on the circumstances of the country in question.

Financial sector reform and liberalisation

A successful reform program requires extensive liberalisation of the economy and integration into the global market. Financial sector liberalisation can be defined ‘as a set of operational reforms and policy measures designed to transform and deregulate the financial system and its structure with the view to achieving a liberalised market-oriented system within an appropriate regulatory framework’ (Johnston and

Sandararajan 1999: 2). Liberalisation brings much needed competition to ensure that firms in all sectors of the economy operate efficiently. There is a general consensus amongst economists on the scope of liberalisation. However, the sequencing of liberalisation is much more controversial. The pre-conditions and the scope of liberalisation policy have been well summarised by Ariff and Khalid (1999) and are presented in the Table 2.

Table 2: Elements of liberalisation policy for development

PRECONDITIONS
1. Development strategy choice among competing models.
2. Good neighbourliness or/and absence of war.
3. Institution-building to strengthen private-sector initiatives via property rights, independent judiciary and effective bankruptcy laws and low taxation. Software for development.
ELEMENTS OF LIBERAL POLICY MIXTURE*
4. Competition policy Domestic real sector competition to improve efficiency: gradual tariff reduction under infant-industry protection; foreign firm entry relaxation after real-sector efficiency improvement.
5. Capital account opening Capital account for domestic firms opened; individuals restricted; later capital account for foreign firms opened.
6. Current account opening for real-sector firms Limited current account openness for individuals; fuller opening of current accounts to individuals later.
7. Fiscal prudence through balanced budgets Taxation reform and tax administration reforms; privatisation programme to limit damage to fiscal sector; build civil service's administrative capacity for reforms.
8. Competition policy for financial institutions Remove or relax entry barriers; modernisation, training.
9. Prudential supervision of financial institutions Build capacity for transparent prudential capacity; emerging economies need higher capital adequacy norms.
10. Central banking independence Slowly restrict central banks to perform monetary functions.

*The numbering does not indicate any particular sequencing of reform steps.

Source: Ariff and Khalid (1999: 454).

The policy mix offered by Ariff and Khalid (1999) involves three preconditions. The absence of internal unrest and cross-country hostilities is fundamental and needs no elucidation. Clear development planning is another important pre-requisite, a lack of which predetermined poor performance in a number of transition countries. Strong

institutions are also an important pre-condition that was often ignored in earlier literature. It is now clear that the fulfilment of these conditions determined the capacity of each country in transition to successfully implement a liberalisation policy.

Johnston and Sandararajan (1999) presented the scope of financial sector reforms in a rather different form. They contended that reforms should include:

- Increasing the autonomy of central banks over monetary management;
- Development of monetary control procedures and money and interbank markets to bolster interest rate regimes;
- Reforming the banking supervision system and prudential regulations;
- Recapitalisation and restructuring of weak financial institutions, supported by enterprise restructuring policy;
- Reduction of the scope of directed loans and interest subsidies and reforming selective credit regulations;
- Encouraging competition in the financial system, and promoting the institutional development of both banks and nonbank financial institutions (NBFIs);
- Development of long-term capital markets, including the domestic public debt management and government securities market;
- Reforming the clearing and settlement system for payments;

- Developing a foreign exchange market simultaneously with prudential regulations on foreign exchange exposure; and
- Elimination of restrictions on payments and transfers for current international transactions and liberalisation of control on capital movements.

The main difference between Ariff and Khalid's (1999) approach and the Johnston and Sandararajan (1999) classification is that former look at the broader picture of interaction between financial sector reforms and macroeconomic management, whereas the latter concentrate only on reforms in the financial sector.

Sequencing of economic liberalisation

The optimum sequencing of reforms for transition economies has been debated for more than a decade. However, this debate has not yet generated any universal consensus. The first economist who tried to develop the precise order of liberalisation for transition economies was McKinnon (1991). Much subsequent literature was based on the critique of his 'optimum order of economic liberalisation'. It is thus appropriate to briefly summarise his approach. Firstly, transition economies should ensure tight fiscal control and a balanced central budget. Establishing an internal revenue service capable of collecting taxes in decentralised market settings is crucial for that purpose (McKinnon 1973). The second task for the policymakers is to open the domestic capital market so that market-based real interest rates prevail. To avoid bank failures and financial breakdowns with 'beyond the clouds' risk premiums that

may impair the repayment ability of any borrower, the pace of deregulation of financial institutions should be linked with the country's overall success in achieving macroeconomic stabilisation. Proper prudential regulations should be established for domestic financial institutions. With regards to foreign exchange liberalisation, McKinnon (1991) argued for an initial liberalisation of the current account with capital account liberalisation later. While liberalising the current account, he recommends substituting implicit quota restrictions with explicit tariffs. To ensure increasing exposure of domestic firms to foreign competition, the authorities should establish and announce a schedule of gradual reduction of tariffs. The final stage in McKinnon's optimal order of economic liberalisation is capital account liberalisation.

Much disagreement with McKinnon's (1991) model focused on (i) whether the domestic financial sector should be liberalised before the trade sector, and (ii) whether the current account should be liberalised before the capital account (see, for instance, Lal and Myint 1999; Sell 1988). Opponents of opening the domestic sector before trade argue that in this case credit will flow mostly to tradable sector, which can lead to the inefficient allocation of credit. By contrast, if trade is opened up first, it can lead to the inability of the domestic sector to compete in the world market, at least in the early stages of reform (Ariff and Khalid 1999). The argument for opening the capital account before the current account was also questioned by Ariff and Khalid (1999) in the light of the recent Asian crisis. Moreover, they summarised the order of sequencing supported by many scholars and advanced four simple prescriptions. First, the governments should bring the budget into balance and reform

the labour market. Second, liberalising the domestic goods market should be followed by liberalisation of the domestic financial markets with a higher level of competition. Third, the current account followed by the capital account should be liberalised. Fourth, these authors particularly emphasised the need to establish well-designed prudential regulations and train capable supervisors before the implementation of financial sector reforms.

CONCLUDING REMARKS

Both the optimum financial system structure and the approach to the transition reforms have been hotly debated since the collapse of the Eastern bloc. To date the outcome of this debate is rather mixed. Nevertheless, on the basis of the arguments presented in this paper, we can draw some tentative conclusions.

In the first place, in relation to the design of financial system, disagreement in the literature focuses mainly on the role of the development of the securities market. The important role of banks is not questioned. Accordingly, emphasis in the early transition years should be directed to the development of the banking sector, and perhaps the government debt securities markets to facilitate monetary policy.

Secondly, in relation to the speed of reforms, economists and particularly policy advisors initially favoured a shock-therapy approach in the search of a quick solution to the transition process. However, with the passage of time, arguments for a gradual approach have acquired greater acceptance. Indeed, various commentators have concluded that, in a world of uncertainty, the gradualist approach has a better

chance of overcoming the *status quo* bias and gaining early political support for it to be implemented. Reform irreversibility is an important issue and may favour the shock-therapy approach. However, from existing empirical evidence, it is clear that although reform irreversibility might often be desirable, it does not always bring positive outcomes in welfare terms. Accordingly, it is important for the gradualist approach to cautiously develop the sequencing of reforms and to secure political support before implementation of each stage of reform. If this is not done, reform may be incomplete and will not bring the desired results.

Thirdly, financial sector reforms in transition economies imply liberalisation. The scope of liberalisation policy has been the focus of attention of various scholars. In spite of different approaches used to define the liberalisation policy mix, the outcomes of this literature verge on unanimity. A general consensus now exists that suggests that financial reforms should include delegating independence to central banks, developing market-based instruments for monetary management, increasing competition in financial services, the establishment and enforcement of effective legislative framework for the functioning of the markets, the opening of current and capital accounts, and the introduction of prudential regulations and supervision.

Fourthly, the debate on the sequencing of financial liberalisation has not yielded a corresponding consensus. However, some general rules have emerged. Thus liberalisation of domestic financial markets should be preceded by the liberalisation of domestic goods markets. Current accounts should also be opened before capital accounts.

Finally, it is difficult to arrive at an optimum financial reform policy purely based on theoretical considerations. Since every transition process is unique, the policy formulation, implementation and outcomes have varied dramatically. Nevertheless, after over 15 years of transition, a reasonable body of empirical evidence has finally become available which provides at least some indication of the ingredients for success.

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