Chapter 12

Sequencing Financial Sector Reforms

12

The development of a financial sector necessarily involves a wide range of policy actions, and structural and institutional reforms. Those actions and reforms cover the design of instruments and operational arrangements for markets; the licensing and restructuring of institutions; and the development of the associated legal, information, and liquidity infrastructure. Given the multitude of policy actions and operational reforms to be implemented, the following question naturally arises: What principles and criteria should be considered in setting policy priorities among various policy and institutional reforms? All financial sector assessments present the findings in priority, showing high-priority actions of some urgency for the short term and then listing medium- and long-term structural measures. How should such priorities be set?

Sequencing is the setting of priorities among financial sector measures, and the appropriate sequencing and coordination of reforms is important for the following reasons:

- Inappropriate sequencing of reforms could cause excessive risk taking and financial instability.[1]
- Limited institutional capacity necessarily requires some prioritization of reform elements.
- Given the numerous policy and operational reforms in each area of financial policy, setting priorities could facilitate and encourage the adoption of reforms; hence, this aspect of financial sector assessments is important.

The sequencing of financial sector policies assumes great importance when issues of capital account liberalization (capital account opening) are under consideration. Recent experience with financial crisis clearly suggests that the mistaken sequencing of capital account liberalization contributed to the speed and severity of crisis in many countries

(World Bank 2001). While there is no consensus on the net effect of capital account liberalization on growth, poverty, and volatility, there is consensus that (a) the effect of financial liberalization (financial opening) on growth depends on institutional quality; (b) the growth effects of financial liberalization could be large and statistically significant for a wide range of countries (in the middle range of incomes and institutional quality); and (c) the development of adequate institutional capacity appears to be an important and necessary precondition for coping with volatility and reaping net gains from liberalization (Obstfeld and Taylor 2004). However, building institutions raises issues of institutional design and of the scope of reform strategies—priorities and sequencing—that need to be understood (IMF 2003a). Thus, sequencing of financial sector reforms is among the core elements of reaping the benefits of capital account opening. Key considerations in such sequencing are discussed in this chapter.

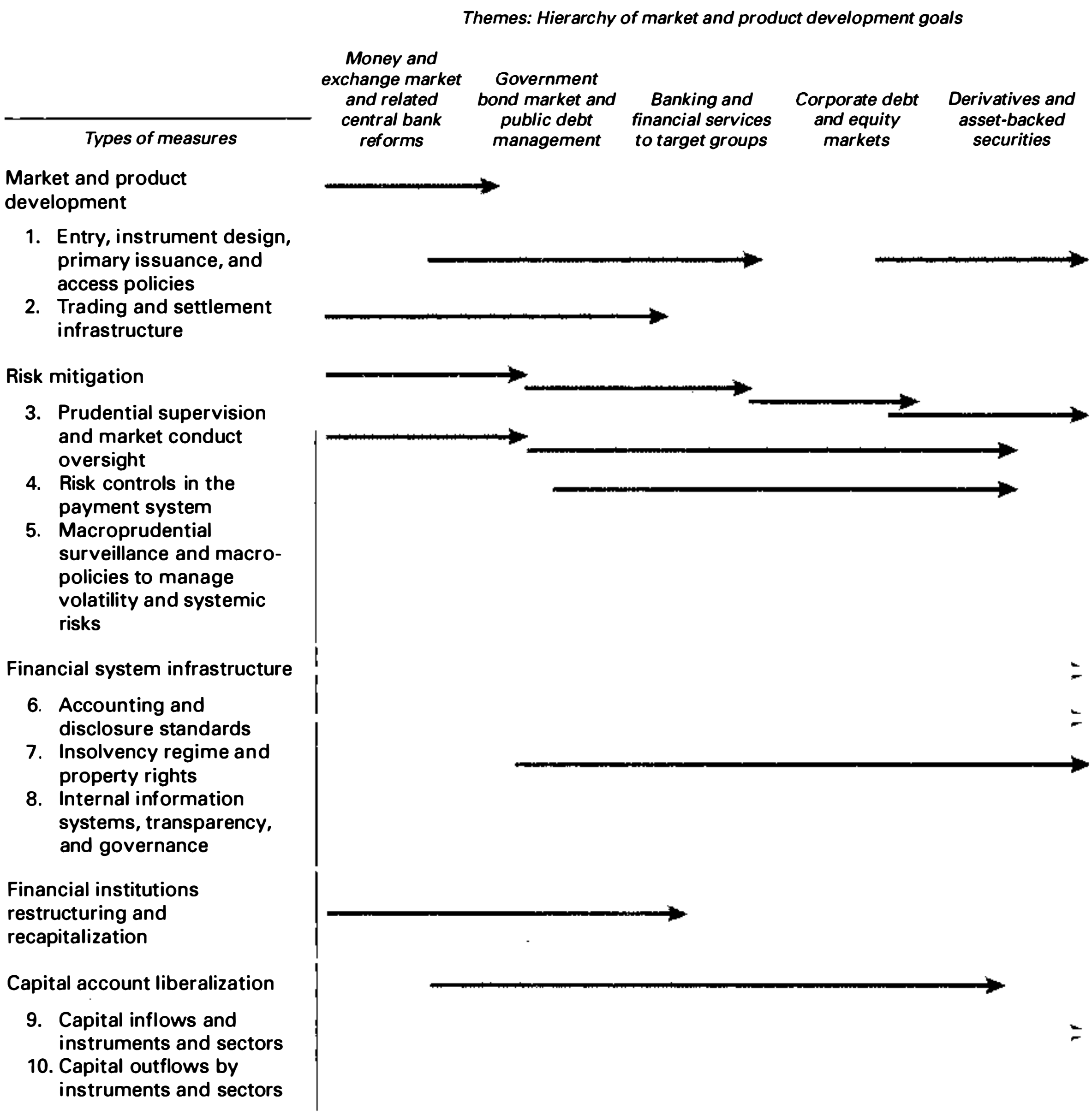
12.1 Development with Stability: The Role of Sequencing[2]

Long-term economic growth hinges on sound financial institutions and deep financial markets to mobilize savings and allocate resources. The liberalization of financial institutions, markets, and cross-border capital flows that are aimed at deepening financial intermediation and capital markets, however, increases risks that often result in financial distress and crisis. As new institutions, instruments, and markets emerge, risks evolve in complexity and magnitude.

The goal of the orderly sequencing of financial sector reform is to safeguard monetary and financial stability during financial liberalization and financial sector development. Strategies to develop local financial markets and intuitions must revolve around mitigating risks injected in the financial system as markets develop and become more sophisticated. Risks consist both of financial risks faced by financial intermediaries and market participants, and of macroeconomic risks that may be triggered by financial liberalization (e.g., loss of monetary control or excessive interest rate volatility following liberalization measures). Thus, market development and liberalization measures would need to be bolstered by parallel measures to mitigate both financial and macroeconomic risks. Financial development policies should also be sequenced to allow adequate buildup of risk management capacity and its associated infrastructure.

The different markets (e.g., money, exchange, bond, equity, and derivatives) and various financial products and services (e.g., credit to target groups and financial services to the poor) that need to be developed may be hierarchically ordered according to the types and complexity of risks to be managed when particular markets or products develop and expand, and on the scope of institutional preparations needed for good governance. This ordering helps set broad priorities among various financial sector segments that need further development, and it constitutes a key preparatory step in sequencing. The top row of figure 12.1 illustrates this key step by presenting various goals for the development of market and financial services in a hierarchical order (see section 12.4 for a further discussion). This hierarchy primarily reflects the complexity of risks that need to be addressed and other short- and medium-term priorities that are country specific. In particular, building and strengthening short-term money markets and risk management

Figure 12.1. Financial Development: Stylized Sequencing of Reforms



Note: Arrows represent the listing measures under each theme.

Source: Karacadag, Sundararajan, and Elliott (2003).

in such markets can set the stage and can facilitate the development and effective risk management—both financial and macroeconomic—of longer-term and more-risky securities. Measures to develop government bond markets, such as promoting primary dealers to provide market-making services, are generally facilitated by the availability of active money markets that are based on treasury bills or other instruments. The development of government bond markets and of a structure of risk-free yields provides the benchmark

for pricing corporate bonds and other more-risky securities and derivative products, thus facilitating risk management. Measures to strengthen the access of target groups such as rural areas and small firms to financial services are medium-term goals that follow a strengthening of the basic banking, money, and government securities markets that help manage macroeconomic risks.

Domestic and external financial reforms thus need to be pursued in a manner that builds the capacity of regulators and financial institutions to monitor and manage the risks associated with a wide range of financial markets, permissible financial transactions, investable instruments, and loanable funds, particularly the following:

- Capital market development-cum-financial stability hinges on establishing the institutional infrastructure for controlling both macroeconomic and financial risks. Macroeconomic risk management requires effective instruments and institutions for monetary and exchange policy implementation, including well-functioning money, exchange, and government debt markets (Ishii and Habermeier, 2002). Financial risk management depends on high standards in corporate governance, accounting, and disclosure, and in prudential regulation and supervision. Those institutional reforms are critical to fostering an environment in which capital markets can grow without undermining financial stability.
- Developing sound financial institutions is a critical component of building capital markets and financial risk-management capacity. Both bank and non-bank financial institutions are the key counterparties in financial markets. They often create and transmit risks. As such, establishing good governance structures—including effective internal controls and risk-management systems—in financial institutions is among the most critical of market reforms.
- Reforms in financial system infrastructure—including the insolvency regime, creditor rights, and accounting and disclosure—and prudential regulation and supervision should start early in the process of market development, given the time needed to implement the reforms and their importance to financial institution restructuring and good corporate governance.
- Capital account liberalization and domestic financial reforms should be approached in an integrated manner (Johnston and Sundararajan 1999). Capital account liberalization by instruments and sectors should be sequenced in a manner that reinforces domestic financial liberalization and allows for institutional capacity building to manage the additional risks, as further explained in the next section.

12.2 Strengthening Access to Foreign Capital

Effective strategies to enhance access to private foreign capital can provide a significant boost to economic growth and poverty reduction, but the benefits of such access can be realized only in proportion to a country's level of institutional development.[3] The rule of law, shareholder protection, adequate prudential regulation and supervision, and financial transparency are significant determinants of whether capital account openness—to enhance access to foreign capital—is beneficial or harmful.

Enhanced access can be achieved by a combination of two approaches:

- Attracting foreign investors and lenders to a domestic market by promoting foreign direct investment, foreign portfolio investment, bank financing from abroad, and infrastructure financing through public–private partnerships.
- Facilitating access to international capital markets by domestic entities, a move that requires certain preconditions of policy environment and institutional preparedness, including credit rating and investor relations.

In addition to sectoral reforms, implementation of those approaches will require financial sector policies that strengthen access to financial services domestically by developing markets, institutions, and infrastructure; that improve investment climate, information provision, and governance; and that are well designed and properly sequenced for capital account liberalization.

Foreign capital can play an important role in developing local financial markets. The timing and use of foreign capital, however, should be selected in a manner that supports its contribution to domestic market development and that limits the cost of additional risk. Accordingly, foreign capital is often best used first to facilitate real sector and institutional reforms, including banking and corporate sector restructuring through privatization (Johnston and Sundararajan 1999). Capital account liberalization should start with the liberalization of foreign direct investment, which helps import the superior technology and management expertise needed to implement operational reforms in financial institutions and corporations. Foreign technology and ownership also promote competition and export growth.

Foreign investors also can serve as an important source of demand for local securities. Liberalizing portfolio investment in equity securities widens and diversifies the investor base for local markets, and it enhances market discipline on issuers in particular and on macroeconomic management more generally (Sundararajan, Ariyoshi, and Ötker-Robe 2002). Opening up to portfolio inflows, however, may increase volatility in market prices, at least for emerging-market economies in the short run (Kaminsky and Schmukler 2003). If one is to limit rollover risk, it is often better to liberalize market for longer-term debts before shorter-term maturities.

However, capital account liberalization should closely complement the domestic market development strategy. For example, allowing short-term capital flows for certain instruments and sectors—with adequate prudential safeguards—can support money and exchange market development. Similarly, the well-planned opening of inflows of foreign portfolio investment can add to the liquidity of domestic equity markets.

Well-developed risk-management capacities of local investors and financial institutions can help domestic financial markets benefit from foreign capital without subjecting markets to excessive stress. Cross-border capital flows, in essence, amplify the wide array of risks already prevailing in liberalized domestic financial markets, including credit, liquidity, market, interest rate, exchange rate, and operational risks. Thus, the risk management capacities of financial institutions and domestic investors have to be strong and sophisticated enough to assess and manage higher degrees of risk in all areas. For example, in hindsight, financial institutions and corporations in South Korea and Thailand (before the Asia crisis) did not adequately assess and manage the risks associated with foreign bor-

rowing and lending. Increased openness to cross-border capital flows also requires a closer monitoring of macroprudential risks to assess the effects of shocks on financial system soundness, and adjustments in macroeconomic policies to limit volatility in key prices.

In addition, it is often desirable to achieve some level of depth in domestic financial markets before exposing markets to potentially volatile capital flows (Ishii and Habermeier 2002). In the presence of a solid domestic institutional investor base, local money, equity, and bond markets are likely to be more resilient against economic and financial shocks that may trigger capital outflows. Potential market volatility and high interest rates resulting from a withdrawal of foreign capital are more manageable and short lived when domestic investors can act as counterparties to foreign investors. Thus, an adequate base of domestic investors can serve to cushion the effect of external shocks, particularly when the nature of the shock is a foreign, rather than a domestic, contagion, thereby fostering greater financial stability. This observation once again highlights the importance of developing institutional investors as a critical component in the sequencing of financial market reforms and development.

12.3 Principles of Sequencing

Risks in developing the specific types of markets, the hierarchy of markets, the demands that markets place on risk management and information requirements, and the various considerations discussed in sections 12.1 and 12.2 can be summarized in the form of certain principles and benchmarks on sequencing and coordinating domestic financial sector reforms (see box 12.1) and these principles are further illustrated in figure 12.1. The principles also apply to capital account liberalization, where the key challenge is to identify precisely how and when foreign capital can enhance market development.

Figure 12.1 highlights and illustrates the principles of sequencing and shows that market development measures need to be combined with measures to manage the risks in developing each area of market development, thereby combining development and stability considerations into prioritized action plan. The top row in figure 12.1 lists various themes—in relation to market and product development goals—according to a hierarchy that is based on risk implications and broader policy considerations, such as restoration of stability and confidence in the midst of a shock or strategic focus on strengthening access to target groups. The themes are ordered from left to right at the top in decreasing order of priority, starting with the themes of highest priority requiring implementation in the short term to ensure stability and effective implementation, and moving right toward more medium-term and structural goals. This hierarchical ordering (i.e., setting priorities) is, as already discussed, based on the complexity of risks and broader policy significance of each theme. That is, markets and themes that involve more complex forms of risk and that require a stronger infrastructure may need to be implemented later than markets and themes that involve simpler and more traditional complement of risks.

The first column lists the broad financial policy areas that must be tackled to achieve the specific market and product development goals under each theme. The types of financial policies listed in the first column of the figure distinguishes between five types of policy actions: (a) market and product development, (b) risk mitigation, (c) financial

Box 12.1 Selected Principles of Sequencing

Principles of sequencing domestic financial liberalization are as follows:

- Liberalization is best undertaken in the context of sound and sustainable macroeconomic policies.
- Capital market development-cum-financial stability hinges on establishing the institutional infrastructure for controlling both macroeconomic and financial risks. Financial system reforms that support and reinforce macroeconomic stabilization and effective conduct of monetary and exchange rate policies should be accorded priority. This principle entails giving priority to central banking reforms to develop monetary policy instruments and money and foreign exchange markets.
- Financial liberalization and market development policies should be sequenced to reflect the hierarchy and complementarity of markets and related institutional structures. Market development policies should be comprehensive. Technically and operationally linked measures should be implemented together, and linkages among markets should be considered.
- Capital market development requires a careful sequencing of measures to mitigate risks in parallel with reforms to develop markets. Policies to develop markets should be accompanied by prudential and supervisory measures, as well as by macroprudential surveillance, to contain risks introduced by new markets and instruments.
- The pace of reforms should consider the initial financial condition and soundness of financial and nonfinancial firms, as well as the time needed to restructure them.
- Institutional development is a critical component of building capital markets and financial-risk management capacity. Establishing good governance structures in financial institutions, including internal controls and risk management systems, is among the most critical of markets reforms.
- Similarly, the operational and institutional arrangement for policy transparency and data disclosure need to be adopted to complement the evolving sophistication of financial markets.
- Pacing, timing, and sequencing also need to take account of political and regional considerations that could strengthen ownership of reforms.
- Reforms that require long lead times for technical preparations and capacity building should start early.

The following are additional principles for external financial liberalization:

- The liberalization of capital flows by instruments and sectors should be sequenced in a manner that reinforces domestic financial liberalization and that allows for institutional capacity building to manage the additional risks.
- Reforms need to consider the effectiveness of controls on capital flows in place or the implicit restrictions on capital flows from the ineffectiveness or absence of markets.
- Transparency and data disclosure practices should be adopted to support capital account opening.

Source: These principles are drawn in part from Ishii and Habermeier (2002) and from Sundararajan, Ariyoshi, and Ötker-Robe (2002).

system infrastructure, (d) financial institution restructuring and recapitalization, and (e) capital account liberalization. The presentation of policy actions in this matrix, which is based on the core principles of sequencing, helps develop a well-coordinated road map of reforms and emphasizes the importance of implementing a critical mass of reforms under each theme that combines market development and risk mitigation. In practice, countries are likely to be in the midst of various stages of market development and risk mitigation, which will be out of synch with any stylized hierarchy of market development themes and the associated sequencing shown in figure 12.1. Nevertheless, the proposed approach in figure 12.1, which is based on principles outlined in box 12.1, can help prioritize future

financial reforms, regardless of patterns of market development in the past, and can ensure that, at each stage, critical reforms are implemented to safeguard stability in the course of market development.

Notes

1. See Johnston and Sundararajan (1999) for some empirical evidence.
2. This section is based on Karacadag, Sundararajan, and Elliott (2003).
3. Issues in facilitating access to international capital markets are discussed in greater detail in IMF (2003b).

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