A NEW PERSPECTIVE ON THE SEQUENCE OF ECONOMIC POLICY TRANSFORMATION AND REGULATION: AN EMPIRICAL ANALYSIS FROM THE DEVELOPING ECONOMY

Huu-Dung Nguyen *

* National Economics University, Hanoi, Vietnam
Contact details: National Economics University, 207 Giai Phong Str., Hanoi, Vietnam

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Abstract

This paper proposes strategies for the gradual and secure transition to a heavily regulated economy. This paper uses a multidisciplinary approach with stylized data obtained from the World Bank for 63 countries between 1980 and 2021. The findings recommend prioritizing macroeconomic stabilization, which includes fiscal consolidation and low inflation, to establish the foundation for subsequent reforms. Subsequently, the government should implement measures to eliminate distortions in domestic goods, labor, and capital markets, thereby enhancing its capacity to collect non-inflationary taxes and generate income. Next, liberalizing international trade can be undertaken to remove quotas, tariffs, and other direct administrative controls. The subsequent phase entails the liberalization of the capital account, aiming to alleviate constraints on both inward and outward flows of foreign direct investment, portfolio investment, and the utilization of long- and short-term financial instruments. Yet, opening the economy is not sufficient. A successful structural transformation needs to be facilitated by upgrading products and services as well as diversifying the manufacturing base to consistently facilitate the process of structural change and maintain economic growth. During the transition period, a stronger constitutional order and rule of law are needed to minimize rent-seeking, which would impede the complete transition.

Keywords: Economic Reform, Economic Liberalization, Economic Integration, Repressed Economy, Removing Distortions

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1. INTRODUCTION

In some recent decades, neo-classical economists have argued that the free-market system is far more efficient than state planning due to its effectiveness in allocation and production (Peck et al., 2018). External interventions should only be implemented when issues like distorted market structures are prevalent (Lin & Chen, 2018). In order to correct the imperfections of the free market system, the neo-classical school concentrates on the analysis of equilibrium rather than the dynamic process of disequilibrium. Sequencing is claimed to have very little impact on real output and prices in the long run (Moore, 2009); therefore, its comparative static results do not provide any path of adjustment to reach the free market state (Marangos, 2002). Rather, it suggests that the optimal strategy for economic reform is booming.

In light of the neo-classical model, since the 1970s, many countries have adopted economic reform and liberalized economies, particularly free trade, privatization, fiscal consolidation, financial deregulation, and liberalization, with the main objective being to promote the growth of their economies. The initial achievements with massive capital inflows and an increase in consumption of some economies in the late 1970s and early 1980s, such as Chile and Britain, have triggered many other countries' economic liberalization programs. Most Eastern Europe and East Asia countries, such as Poland, Bulgaria, and Vietnam, later began adopting the transformation of their economies from the centrally planned economy, which is highly repressed and distorted by governments mandated control over output and prices, into some form of economic liberalization (Le, 2019). Liberalization has been considered a miracle for attracting foreign investment and economic development.

During that phase, economic expansion led to a change in the economy's structure, mainly due to higher demand and a subsequent rise in incomes. Production activities aligned themselves with this demand-driven structural change. Simultaneously, structural change played a pivotal role in driving economic growth from the supply side as labor shifted from low-productivity sectors to higher-productivity sectors. The transfer of labor between sectors has been found to promote growth in earlier stages, but productivity increases within sectors have been found to promote growth in later stages. Labor migration away from the agricultural sector was observed globally as the services sector gradually emerged as the dominant employer and contributor to economic output in several countries. Generally, the process of economic development has been closely linked to the significant restructuring of some economies.

Unfortunately, the process of structural restructuring has not yet reached its full completion. The need to address the neglect of agriculture and prioritize manufacturing is evident in numerous countries, alongside the crucial importance of harnessing the synergistic relationship between manufacturing and services. The sustainability of economic growth and the completion of structural transformation are contingent upon the absence of any weak links within the three sectors. As a result, after some initial success period, the pictures of liberalizing countries become various. In the late 1980s and early 1990s, some countries, such as Chile and Britain, continued to have remarkable achievements, while others, such as Argentina, Brazil, Peru, and the former Soviet Union, experienced recessions or even financial crises and economic instability. In Asia, after a miracle economic development period in 1970–1995, many Asian countries also plunged into financial crises and recessions in 1997 (Razmi et al., 2016), and some countries have stuck in the middle-income trap until now.

Furthermore, the emergence of a novel form of globalization, characterized by the convergence of the adverse effects of the COVID-19 pandemic and the Russian invasion of Ukraine recently, has significantly amplified the profound transformations occurring in the realms of economy, politics, and technology. Various phenomena have emerged that challenge the conventional understanding of historical progress, such as the simultaneous occurrence of diminishing pent-up demand (Mester, 2021), persistent supply-side disturbances fueling (Sülün, 2020), inflation hiking (Macchiarelli et al., 2021), and monetary- and fiscal accommodation withdrawing (Guénette et al., 2022), just to name a few. The escalation of risk pertaining to fundamental shifts in driving forces and regulatory processes within the field of economics has the potential to yield adverse outcomes, particularly in terms of political upheaval.

Many political economists in many countries blame that continuing rapid transformation may trigger economic turbulences such as unemployment, fiscal and financial instability, and political bust-ups. They argued that inappropriate policies, particularly the timing and sequencing of liberalization, were one of the main issues (Bremmer, 2010). This has sparked renewed interest in an optimal order of economic liberalization that a country should follow to mitigate the expenses associated with reform and minimize any detrimental impacts on the economy. However, political economists still fail to prescribe a clear path for the liberalization of the economy.

This paper explores the process of economic integration and transformation for a predominantly regulated economy. It examines how such an economy can safely and effectively transition towards openness while also addressing the efficient allocation of labor and resources towards more productive activities, especially under economic turbulence.

The paper is organized as follows. Section 2 provides a review of the literature. Section 3 represents methodology and data collection. Section 4 outlines the results and discusses them. Section 5 concludes the paper.

2. LITERATURE REVIEW

Economic transformation refers to the shift from a predominantly regulated economy to one that places greater emphasis on market forces. Over the past few decades, researchers have made efforts to provide policy recommendations to tackle the challenges impeding economic transformation in developing nations. Initially, research mostly concentrated on the liberalization of trade, but over time, the emphasis switched to the liberalization of current and capital accounts, as well as the relationship between structural changes and stabilization policies. However, the discourse surrounding the reform packages in the literature has been fragmented. They primarily focused on sector-specific assessments, and the results have been inconclusive (Jayne et al., 2021; Jung, 2021).

In favor of rapid reform, Devarajan et al. (2001) claim that rapid reform encourages the movement of resources, leading to a quicker and more cost-effective adjustment compared to a longer relocation process. Furthermore, expediting the reform process enables more effective synchronization in the execution of the reforms (Murphy et al., 1992). The swift implementation of comprehensive changes not only enhances the legitimacy of the reform process but also encourages the private sector to promptly reallocate resources and boost investment (Lardy, 2019). Under the conditions of frictionless competitive equilibrium, the optimum level of welfare is achieved by eliminating all distortions at the same time in all sectors. Besides, the reform package can be more effectively implemented if it is introduced quickly enough to overcome the political opposition to protracted reforms (Jenkins, 1992).

On the contrary, some researchers support gradualism and argue that gradual reform is needed, especially when reforms require instruments that may conflict with particular goals (Kern & Howlett, 2009). For example, the implementation of exchange rate policy contradicts the simultaneous implementation of trade and capital account liberalization. This is because exchange rate policy necessitates an appreciation, while trade and capital account liberalization require a depreciation (Henry, 2007). Attempting to adopt numerous reforms simultaneously is not feasible, and even if attempted, it requires a significant amount of time for their execution (Fischer & Gelb, 1991).

Additionally, Malesky and London (2014) contend that gradualism has the potential to lower the costs associated with making adjustments because, in reality, shifting resources between different sectors of the economy cannot occur instantly and without expense. For instance, Dewatripont and Roland (1992) analyze the advantages of a gradual approach compared to a rapid one in the context of industrial restructuring. He reveals that implementing rapid reform may prove to be excessively expensive because it would require providing exit bonuses to all terminated employees, regardless of their varying alternative prospects. Dewatripont et al. (1995) also observe that, if reversing the reform process incurs significant costs, implementing changes gradually makes them simpler to undertake because it maintains the option of early reversal. If the initial reforms prove successful but require the implementation of less popular measures for maintenance, people will face a decision in the next phase: either they opt for a costly reversion or embrace additional reforms. Furthermore, by spreading the costs of adjustment over time, the political sphere is likely to support a gradual implementation strategy (Agénor & Montiel, 2015), thereby minimizing adjustment costs.

Considering the divergent viewpoints, it seems challenging to find common ground between gradualists and big bang advocates. However, we can achieve this by identifying the optimal adjustment trajectory that not only minimizes transition costs but also takes into account various financial and structural constraints. A policy sequence of this nature should aim to maximize the country's intertemporal social welfare function.

3. RESEARCH METHODOLOGY AND DATA COLLECTION

This article uses a multidisciplinary approach to explore growth trajectories that result in a more transformative direction. Figure 2 illustrates the framework for examining four dimensions of a country's economic change.

Figure 1. The four-step analysis economic transformation inquiry

We use stylized facts and historical evidence pertaining to contemporary industrialized economies, as well as more recent data encompassing a wider range of developed and developing countries. The data was gathered from the World Bank in 2023, a compilation of 63 countries from 1980 to 2017.

In constructing our data, we took as our starting point the real gross domestic product (GDP) of the sampling countries. The countries are divided into two groups based on whether their GDP per capita is above or below the median. We decompose the labor productivity growth into five constituent components. Three of these components pertain to the increase in average labor productivity within the agriculture, industrial, and services sectors, while two components result from workers shifting from one sector to another. The process of reallocating labor between sectors involves both a "static" and a "dynamic" component. Static reallocation refers to the process of shifting manpower from agricultural to alternative sectors. Dynamic reallocation refers to the process of shifting manpower within the higher productivity industry and service sectors. The static element is positive (negative) when labor transitions from work with lower (higher) productivity to work with greater (lower) productivity. When the average labor productivity of the receiving sector increases or decreases during labor transfer, we consider the dynamic element as positive or negative. We categorize the time periods based on income groups and whether each group's per capita income growth exceeds or falls short of the global average.

4. EMPIRICAL RESULTS AND DISCUSSION

4.1. Macroeconomic stabilisation

In order to set the stage for future reforms, previous research often indicates that macroeconomic stabilization — which includes fiscal consolidation and low inflation — must be a top priority. This is because, fundamentally, a highly repressive economic system is typically characterized by the government owning the means of production. The government assumes control over price determination, production levels, and product and service distribution. This system exhibits a strong government desire for equal distribution of wealth, low inequality, and unemployment elimination (Nuti, 2023). However, the real results were often far behind expectations because of little competition, innovation, and incentives to work hard (Griffin, 1998). The exploitation of natural resources primarily drives their economic expansion, leading to environmental challenges. Furthermore, high-quality labor and science make very limited contributions. Economic restructuring is stalled as a result of the uneven and fragmented development of three major economic pillars: industry, services, and agriculture (Kinossian, 2022). Consequently, their economic development is often slow, while macroeconomic indicators are volatile, with a high budget deficit and rising public debt (Günther et al., 2024). Under such circumstances, most of these severely repressed economies have undertaken significant economic management reforms, including those pertaining to pricing, enterprise autonomy, the planning system, agricultural organization, and foreign trade.

During the transition process, the economy particularly experiences turbulent times. Policymakers may need to explore unconventional strategies for monetary and fiscal policy, which could involve significant changes to the current policy framework. Both theory and experience generally agree that macroeconomic stabilization is a crucial precondition for economic liberalization in order to reduce volatility and generate growth that benefits welfare (Coenen et al., 2021). Macroeconomic stabilization refers to fiscal control and price stability, in which fiscal consolidation is suggested to be taken in the first place. Macroeconomic stability provides protection against interest rates and currency fluctuations in the global market (Jalles, 2021). Uncontrolled inflation, massive debt loads, and currency swings can lead to a breakdown in GDP and an economic crisis (Nuti, 2023). Besides, it would be difficult for the government to conduct monetary policies during the transition period without fiscal consolidation and inflation under control because of the potential loss of macroeconomic control when monetary policies are dependent on the government budget deficit (Jalles, 2021).

In this regard, Argentina can serve as a prime example. Argentina faced a severe economic crisis in 1976 (see Table 1). Its fiscal situation was not bad prior to the limitary government in 1977. However, the government failed to effectively address the fiscal situation by revamping the tax system, resulting in a persistent budget deficit throughout the late 1970s. Because of the large budget deficit, the monetization of the budget deficit, which makes inflation rampant, has shot to over 500 percent (Thornton, 2008). This leads to a fall in international competitiveness. Exporters had to struggle with exporting to other prevailing countries, causing a failure in liberalizing trade. In the subsequent period, the volatility of Argentina's GDP is relatively similar to that of low-income countries illustrated in Table 1 (countries are divided into two groups based on whether their GDP per capita is above or below the median) Argentina eventually had to reintroduce direct administrative control (Ferrandino & Sgro, 2015). This circumstance indicates that a stable macroeconomic environment, including fiscal consolidation and low inflation, must be established before other reforms can be implemented.

Table 1. Macroeconomic stability for high- and low-income countries

Indicators	*2001–2010*		*2011–2020*	
	Low income	*High income*	*Low income*	*High income*
Average growth	3.57	3.03	3.88	1.91
Volatility	2.82	1.18	2.06	1.92
Cycle amplitude	5.72	3.17	6.29	6.38
Observations	63	63	63	63

Source: Author's elaboration.

To reduce the budget deficit, direct government spending should share a very small proportion of GDP. Losses from the central bank should also be reduced. Since the central bank in a highly repressed economy usually has to subsidy the public sector and households, losses occur. This loss contributes considerably to the budget deficit. By phasing out or folding in off-budget government subsidies, the central bank can avoid potential losses from subsidies for domestic deposits or credit in the public sector and households and, hence, be able to avoid overprinting money, which causes harmful inflation.

Inflation, which is related to maintaining a stable price, is another important issue that needs to be under control. The tax system should be strengthened to help repress inflation. As economic liberalization is in progress, the government usually has to privatize and give up its ownership of enterprises, which are means of production (Rhee & Metrick, 2020). However, leaving its own means of production raises the threat of inadequate revenue. Developing a tax structure is essential to recovering the revenue lost by relinquishing those enterprises. Chile is a successful example when its government takes the right liberalization approach. Besides eliminating subsidies, the Chilean government introduced a new tax system imposing value-added tax at a uniform rate of 20 percent (Letelier & Dávila, 2015), which provided stable revenues for the budget. As a result, the GDP of Chile increased from negative 13.5 percent in 1973 to positive 3.7 percent in 1976 and maintained a surplus throughout 1977–1980 (French-Davis et al., 2000). If the tax system is inadequate for generating government revenue, there is a risk that the government may accumulate significant debts or resort to printing money to fund budget shortfalls. This causes inflation and distorts prices, giving off all the wrong signals during the process of trade reform and eventually defeating the purpose of reform.

However, the pace of privatization should not be too fast so that it will not put too much pressure on the fiscal system. In fact, privatization should be in parallel with the development of the tax system to ensure enough collection of government revenue. Some industrial and natural assets can remain under government ownership initially and then be broadened as the tax system becomes adequate.

4.2. Removing distortions in domestic goods, capital, and financial sector

The subsequent phase following the attainment of a stable macroeconomic environment, characterized by fiscal consolidation and low inflation, involves the elimination of distortions within the domestic goods, capital, and financial sectors. The elimination of distortion entails the deregulation of domestic interest rates, the eradication of price distortions, and the liberalization of salaries in the labor market (McKinnon, 1993).

It is necessary to remove distortions in banking systems so that banks are free from setting "standard" interest rates. Relaxing the interest rate ceiling allows for positive interest rates and thus increases financial depth, raises the level of savings, and improves the quality of investment (Hallwood & MacDonald, 2000). The elimination of credit and interest rate controls followed by macroeconomic stabilization has potentially important effects on monetary and credit aggregates. In addition, the banking system should be free from reserve requirements and official guidance in setting the standard interest rate after tight fiscal controls are in place so that the government does not have to rely on inflation tax to generate revenue. However, the pace at which banking institutions are deregulated should be synchronized with the attainment of macroeconomic stability. Macroeconomic stability provides a prudential foundation for price level stability. If price level stability is not sufficient, interest rates will experience unpredictable volatility. This leads to unrestricted domestic borrowing and lending by deposit-taking banks. Deposit-taking banks have incentives to take short-term deposits and lend long-term; hence, duration mismatches occur. Ultimately, this can lead to panic or the collapse of the banking system. Making sure the safety payment mechanism exists is essential.

Poor regulatory and supervisory structures contributed significantly to the failure of the whole process of liberalization (Cho, 2002). The presence of moral hazard problems in the financial systems of most highly repressed economies is due to explicit or implicit deposit guarantee schemes or many forms of government support. Moral hazard makes banks behave as risk takers, set interest rates at higher and riskier levels than they would be, and tend to lend aggressively, thus providing wrong signals to the non-banking sector about future returns. Overborrowing and a potential increase in non-performing loans will occur. If the economy were not opened up to the international capital markets, then the domestic problems would be absorbed locally and the economy would not suffer severely. However, if the capital account had already been liberalized by that time, overborrowing would take place and result in serious problems (McKinnon & Pill, 1997). Adequate supervision and regulation are necessary.

The financial crisis in Mexico in 1994–1995 is evidence of the importance of supervision and regulation. In the 1980s, Mexico started to deregulate its financial sector. With its privatization and deregulation, bank credit to the private non-financial sector grew rapidly from 10 percent of GDP in 1988 to over 40 percent of GDP in 1994 (Gallardo et al., 2006). The currency-denominated liabilities of banks shot from 116.4 billion pesos in 1993 to over 213 billion in 1994 (Mishkin, 1996). During the lending boom, a lack of proper supervision and oversight led to non-banking financial firms expanding their credit activity and taking unnecessary risks. Since Mexico had high inflation and its debt structure was mostly short-term with the same due maturity and denominated in foreign currency, the banking system became fragile and vulnerable when interest rates in the United States (US) in 1994 put upward pressure on interest rates in Mexico. Under a pegged exchange rate, Mexico's central bank has to increase interest rates to keep the peso's value. Interest rates increased, leading to an increase in asymmetric information and adverse selection problems in the financial markets. This intervention exhausted Mexico's international reserves, and ultimately, the government had to devalue the peso in 1994. Lending fell sharply at the same time, with the increase in investor withdrawals, which caused Mexico to fall into a deep recession in 1994 (Robertson, 2004). Mexico clearly did not have macroeconomic stability before opening the financial sector; hence, it failed to liberalize the economy at that time.

Highly repressed economies in the initial stage of development are much segmented domestic goods and financial markets (Duong & Izumida, 2002; Ho & Iyke, 2017). The number of transactions in the financial markets is low as a result of the lack of financial instruments available in other money markets and capital markets, as well as the fact that commercial banks continue to retain a relatively high excess reserves ratio (Minh & Dung, 2017). The central bank's less sophisticated payment mechanisms closely relate to this. Commercial banks have no incentive to reduce surplus reserves because of the high return rates on those reserves. As a result, there is less demand for interbank borrowing. Further reform of the reserve system and the effectiveness of the central banks' payments and financial markets as a whole are consequently necessary for the growth of the financial markets.

4.3. Liberalization of international trade

Since a highly repressed economy is typically subject to significant quantitatively protected constraints, liberalizing international commerce requires the removal of quotas, tariffs, and other direct administrative controls, as well as a reduction in tariffs across the board. These protections are administrative controls, either indirectly or directly. Administrative controls can be many sets of tariffs or subsidies. These tariffs or subsidies, however, highly distort prices, either directly or indirectly, rather than "equivalent" tariffs. This provides the market with the wrong signals, causing the economy to drift away from its optimal equilibrium. It is necessary to replace these quantitative quotas and administrative controls with appropriate tariffs.

Liberalization of international trade should be undertaken gradually and in parallel with decontrolling prices in the domestic trade of goods and services. The implicit structure of tariffs should be carefully approached because it can cause the collapse of domestic manufacturing. Subsidy for producers, for example, is in order to keep effective domestic prices of primary input below some countries that are prevailing in the world. Removing it can cause domestic producers to lose their target markets and end up in bankruptcy. When analyzing the liberalization process of the former socialist economies, McKinnon (1993) suggested that the optimum order of liberalizing foreign trade for highly protected economies may begin by converting their implicit quota restrictions into explicit tariffs, such as preannouncing the adjustment or establishing a special international economic zone for international operation, then expand rights to other places. This has been successful in some countries, such as Chile's liberalization. Chile has undergone a remarkable reform. During five years' time, most quantitative restrictions on foreign trade were removed, and tariffs were reduced to a rate of 10 percent from an average rate of 94 percent (Harrison et al., 2002; Mizala, 1998). By the end of 1976, the government had accomplished the unification of the exchange rate and eliminated all restrictions on payments for current transactions. The reform was preannounced and carried out according to schedule, which contributed to its success.

However, free international trade does not mean extending full foreign exchange convertibility to capital account transactions. Let strong foreign currency circulate in parallel with relatively weak domestic currency, which may cause destabilization. Moreover, as long as domestic banks remain restricted, there is no point or even destructiveness in allowing foreign banks to operate freely in domestic markets.

After current account liberalization, the opening of capital accounts can be implemented. Opening capital accounts at the earlier stages of the reform may result in large inflows of foreign capital due to substantial interest differentials. Under both fixed and floating exchange rates, these inflows will result in a real appreciation of the domestic currency. Since financial markets adjust faster than goods markets, this real appreciation may be destructive for the economy.

4.4. Liberalisation of capital account

The process of liberalizing the capital account involves the gradual reduction and eventual elimination of limitations on both inward and outward movements of foreign direct investment, portfolio investment, and the utilization of long- and short-term financial instruments. This enables domestic residents to freely borrow from or deposit in international markets. Foreign exchange is freely convertible on the capital account.

Liberalization of the capital account will help the economy gain lots of benefits. Liberalization of capital accounts brings about freedom of choice for investors and borrowers in choosing and exchanging assets. The diversification of assets offers investors risk diversification to avoid unexpected losses. As the economy becomes more integrated, it creates more capital channels for evasion. In addition, resource allocation is also more efficient through increased completion of financial resources. Restriction on capital transactions not only creates a loss in effectiveness but also incurs high administrative costs, distorts the economy, and raises corruption and rent-seeking behavior.

However, there are some critics of capital liberalization. When we liberalize the capital account, the ability to carry monetary policy autonomy and exchange rate stability will be reduced simultaneously. Macroeconomic management for excessive capital inflows may be even more difficult. Excessive capital inflows may go beyond the absorptive capacity of the banking system, creating inappropriate lending decisions that lead to financial fragility. Overborrowing syndrome may also occur. However, these disadvantages can be avoided if capital account liberalization is approached in sequence.

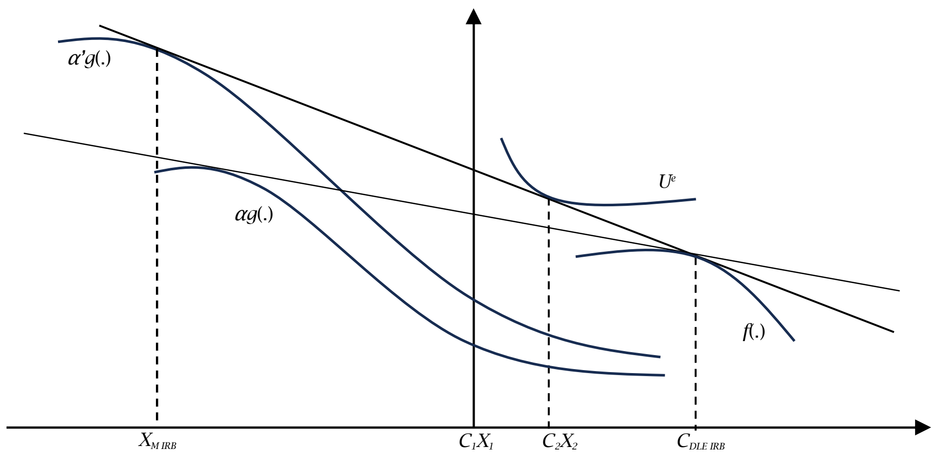
It is widely accepted that capital account liberalization should be the last step in the economic liberalization procedure. Because success in trade and financial reform leads to capital inflow (Santos-Paulino, 2002), the domestic currency will have a real appreciation, which will reduce competitiveness. However, the successful liberalization of trade requires a real depreciation in order to support exporters (Dornbusch, 1992; Santos-Paulino, 2002). The opening of the capital account is likely to result in an appreciation of the currency, which in turn may lead to a decrease in profitability within the tradable goods sector. This decline in profitability occurs at a time when the industry is already undergoing an expensive process of readjustment. As a result, it is advisable to avoid the simultaneous opening of capital and current accounts and to exercise strict control over capital inflows during the process of trade reform, with the opening of capital accounts being deferred until the final stage.

However, some economists (Donges & Kasper, 1971; Gregori & Giansoldati, 2023) advocate for the establishment of the capital account either before or concurrently with the current account (Moschella, 2012). The main argument was to use foreign funds available due to the opening of capital accounts to smooth the adjustment process and provide assistance to industries that are negatively affected by the trade reform. When the trade barriers are reduced, domestic relative prices will change, and resources will be reallocated across the sectors. To enhance the success of trade reform, these authors argued that adjustment costs, such as unemployment associated with the reduction of tariffs, should be kept as low as possible. To accomplish this, they recommended that liberalization of trade should be implemented slowly and that assistance, which is usually in the form of foreign funds, be provided to finance a smoother adjustment by the import-competing industries. These arguments, however, have some loopholes. In fact, trade liberalization should not be undertaken based on short-term capital inflows or on credits from foreign countries or international agencies released from capital account liberalization. Such capital inflows may not be viable in the long run and also generate incorrect market signals during the liberalization process, which are harmful to the economic liberalization process as a whole.

Moreover, liberalizing capital accounts is also strongly strengthened by the theoretical approach known as an overborrowing syndrome (Choudhary et al., 2016; McKinnon & Pill, 1998). A country falls into "overborrowing syndrome" when it undertakes successful "real side" economic reforms and removes distortions in liberalizing international trade. It tends to borrow too much from financial institutions to finance investment and then faces the problem of repayment for the loans. The main root of the overborrowing syndrome is a moral hazard spreading in the banking sector.

The sources of moral hazards in the financial system that generate market failure, which leads to overborrowing, are likely to include explicit or implicit insurance, government guarantees, and fixed exchange rate policies. This is because, on the liabilities side, banks have an informational advantage and also enjoy explicit or implicit government guarantees by bailing out if necessary. On the asset side of the balance sheet, banks are the vital source that domestic firms can borrow from to finance their investments. When the economy is liberalized domestically (see Figure 1), the non-banking sector starts to borrow from domestic capital markets. Some firms invest in new technology, some in old technology, and some put savings into banks. However, in assessing investment risks, commercial banks may take too aggressive risks due to being too optimistic about investment in the reforming economy (McKinnon & Pill, 1998). The moral hazard will induce the banks, which are subject to both credit risk and currency risk, to borrow unhedged excessively to finance domestic investment. However, during an economic downturn, when bank borrowers fail to repay the loans, the banking sector can systematically go bankrupt. Then it leads to the loss of foreign investors' confidence, which eventually results in a financial crisis.

Figure 2. Domestically liberalized economy (DLE) rational-belief equilibrium

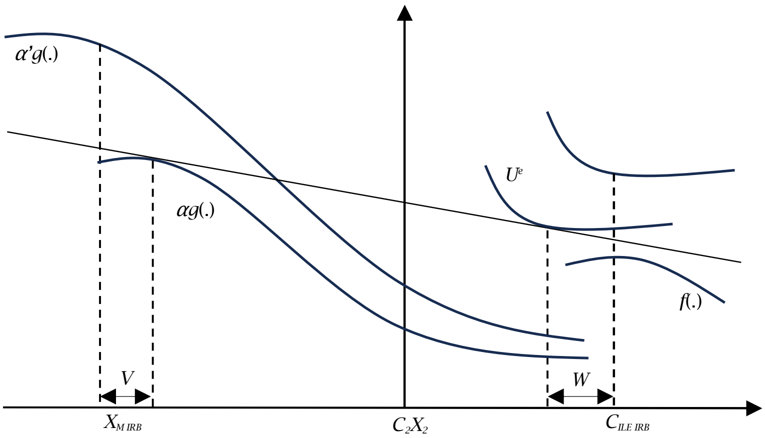


Source: Adapted from McKinnon and Pill (1998).

Assuming that investment returns in period 2 in Figure 2 are known with certainty, the market works efficiently. The problem occurs when banks exploit moral hazard, which exists in the domestic capital market due to the implicit and explicit government guarantee of bank deposits. When prudential supervision is insufficient, banks start to lend aggressively and send a wrong signal to the non-bank sector about futures on investment, represented by the function $\alpha' g(.)$. When an investment turns out to yield less than anticipated, borrowers cannot repay the loans and ultimately end up with bankruptcies. If the economy is not opened to international markets yet, this problem can be solved with little cost (McKinnon & Pill, 1998). Although firms and households expect their future income to be high, the sharp increase in the domestic interest rate restrains consumption and investment. Thus, it does not lead the economy into serious overinvestment and overconsumption.

In period 1, when the domestic economy opens to the international market, all firms and households become net borrowers. Firms tend to borrow money from abroad too much and channel it to domestic lenders. As a consequence of the moral hazard dilemma, there is an anticipation that, in the event of a crisis, either the national government or international institutions such as the International Monetary Fund (IMF) or the World Bank will provide financial assistance to mitigate the situation. Simultaneously, financial institutions will engage in heightened borrowing activities from both domestic and international capital markets in order to secure funds for domestic investment and consumption purposes. If this credit expansion is not regulated appropriately at that time, overinvestment and overconsumption will eventually become apparent (Choudhary et al., 2016). As shown in Figure 3, the function $\alpha' g(.)$ represents the wrong anticipated pay-off on investment, and, as a result, consumption and investment levels increase. Overconsumption and overinvestment occur as a result of banks' aggressive lending and sending wrongly optimistic signals to non-banking sectors. Overconsumption and overinvestment are represented by W and V, respectively (see Figure 3).

Figure 3. Internationally liberalized economy (ILE) rational-belief equilibrium



Source: Adapted from McKinnon and Pill (1998).

If prudential supervision is inefficient, risk-neutral banks will shorten the true probability distribution of futures by overly discounting the possibility of bad outcomes. Thus, risk-neutral banks could run their loan programs overly optimistically. Unaware of bank supervision's inadequacy, firms and households take this overly optimistic signal at face value and bid eagerly for funds to exploit the fake higher returns. This corresponds to what Kurz (1994) called rational belief equilibrium. Under deposit insurance, loosely supervised banks prefer to gamble with government money.

Effective banking supervision ensures that regulators prevent banks from taking advantage of moral hazard and ensures that credit conditions appropriately reflect the privileged information about macroeconomic development that is possessed by the banking sector. However, when authorities fail to effectively address moral hazard, they may distort the implicit signal in lending conditions, which could result in excessive borrowing and increased financial and macroeconomic instability. As banks signal higher payoffs for investments than the reforms warrant, increased consumption and investment make savings decline and the current account deficit. This situation is unsustainable unless the economy sees a lucky payoff in the future. Firms will have a wide spread of loan defaults, which will cause the domestic banking system to seize up and could require a bailout from foreign indebtedness (Efremidze et al., 2016).

Unhedged currency risk can also contribute to the overborrowing syndrome. Usually, the interest rates in the international market are lower than those in countries with reform programs. Domestic banks will borrow a foreign currency at favorable interest rates and then lend to domestic residents at comparatively higher interest rates denominated in domestic currency. The banking industry is plagued by moral hazard, leading domestic banks to engage in borrowing activities in foreign currency without implementing appropriate hedging strategies. This behavior is primarily driven by the implicit or explicit protection provided by deposit insurance and other government guarantees. Moreover, in developing countries with fixed or pegged exchange rate policies, banks typically take unhedged foreign exchange positions when borrowing money in foreign currency, as the fixed exchange rate policy implicitly guarantees minimal fluctuations in the exchange rate. If there is a sudden economic downturn and the domestic currency depreciates, the loan from abroad in foreign currency will increase abruptly in terms of the domestic currency. In countries where governments provide implicit and explicit deposit insurance and adopt a fixed exchange rate policy, banks have the capability to extend credit to the private sector at artificially low interest rates. Consequently, these banks tend to transfer a significant portion of the currency risk, which arises from borrowing without hedging, onto the government in an implicit manner.

If domestic regulatory authorities permit banks and financial institutions to concurrently undertake credit and foreign exchange risks, it is improbable that the regulatory framework will endure. In numerous emerging economies, it is observed that instances of bank borrower defaults tend to instigate currency devaluation, resulting in substantial capital losses for banks. The potential outcome of bankruptcies is the erosion of foreign investors' trust, which may ultimately result in a currency crisis in various nations, such as Mexico. Mexico fell into crisis in 1994–1995 after starting to embark on economic reforms in the mid-1980s. Starting to move toward free trade, Mexico had undertaken an intensive structural reform focusing on privatization, deregulation of domestic industry, and fiscal consolidation (The World Bank, 2016). The banking sector was privatized, reserve requirements were reduced quickly, and bank credit controls were lifted (Sidaoui et al., 2010). It had also undertaken financial reforms, renegotiated its external debts, and made great efforts to open up trade. The reforms favoring free trade attracted large capital inflows, particularly after 1988. The major capital inflows were foreign portfolio investments, which are more volatile than other forms of investment. This implies the country's vulnerability to capital flight during the economic downturn. However, foreign direct investment kept rising at a moderate rate while portfolio investment rose considerably (see Figure 1). These large capital inflows were also consistent with the interest rate differential, where the domestic rate was higher than the foreign rate. These capital inflows were one of the main causes of the external current account deficit (David & Leigh, 2018). These phenomena reflect the high risk of overborrowing.

Overborrowing and overconsumption arise when banks exploit the moral hazard implied by the government guarantee (Vulovic, 2010). As the capital account of Mexico was open, commercial banks borrowed internationally at a low interest rate. Without adequate and effective regulations, banks tend to overborrow and overlend. Banks's overlending sends the wrong signal to the non-banking sector and households; hence, they increase their consumption and investment with the expectation of higher future payoffs. As a result, savings declined and current account deficits arose. Private savings in the GDP of Mexico fell by half between 1984–1990 and 1991–1993. Imports grew at nearly 50 percent per year in seven years from the beginning of reform to the crisis (Mishkin, 1996). In the meantime, the rapid growth of domestic credit is reflecting easier access to credit following the financial deregulation and privatization of commercial banks. According to Hagendorff (2015), there was a significant increase in commercial bank credit, housing credit, and consumer credit in 1994. In real terms, commercial bank credit increased by over 100 percent, housing credit increased by a remarkable 1000 percent, and credit for consumption increased by more than 45 percent. Both banks and the non-banking sector expanded their loans by taking on excessive risks. As a result, many loans are bad. These significantly contributed to a worsening balance of payments in Mexico in 1994.

In addition, the pegged exchange rate policy of Mexico has implicitly guaranteed that there will be no changes in the value of the peso. This encourages banks to tend to overborrow unhedged, leading to excessive exchange risk (Martinez, 1998; Rhee & Metrick, 2020). Before the 1994 crisis, foreign currencies, primarily the US dollar, constituted a significant portion of banks' total outstanding credit (Martinez, 1998). In 1994, Mexico was compelled to adopt a floating exchange rate regime due to several factors, including the recognition of the real exchange rate, the escalation of short-term external debt, and the presence of a substantial current account deficit. Mexico had undertaken reform without order. In other words, it had taken capital account liberalization simultaneously with the privatization of banks without sufficient attention to improving supervision and regulation (Cabello et al., 2004). Moral hazard led to overborrowing and overlending, which eventually caused a currency crisis and a financial crisis in Mexico in 1994.

The financial crisis in East Asian economies in 1997 again confirmed the necessity of the order of economic liberalization. Despite the East Asian economies' sustained macroeconomic stability through fiscal discipline and moderate inflation rates, which fueled their rapid economic growth for many years, the events of 1997 exposed the weaknesses of their financial systems (Rhee & Metrick, 2020). Countries such as Thailand, Malaysia, and Indonesia had a substantial amount of external debt, mostly characterized by a short-term maturity profile. They denominated the majority of these debts in US dollars and Japanese yen. They also have a pegged exchange rate regime and consistently continued this policy until international reserves were almost exhausted just before the crisis happened. Poor banking regulation and supervision also contributed greatly to the collapse of the financial systems of East Asian economies in 1997, and this should be an important lesson for newly transforming countries.

4.5. Policy selection and implementation for economic transformation

In reality, economic integration is only a part of the larger transition as a whole (Sachs et al., 2000). In the early stage of the transition process, in order to run the transition, the government often only needs to weigh the pros and cons of economic integration at the margin through trial-and-error experiments to search for each step toward a market economy with little understanding of the optimization solution. However, in the later stage, the economic transformation agenda places higher demands on policymaking and implementation beyond merely integrating the economy (Aminuzzaman, 2013).

Following the liberalization of international trade, governments often need to promote investments in labor-intensive manufacturing sectors, like garment production, to generate employment opportunities, especially in developing countries with ample labor resources. Manufacturing contributes to labor productivity growth by virtue of its tradable nature, extensive capital investment, and utilization of modern technologies. Such a structural transformation towards manufacturing has usually been referred to as industrialization.

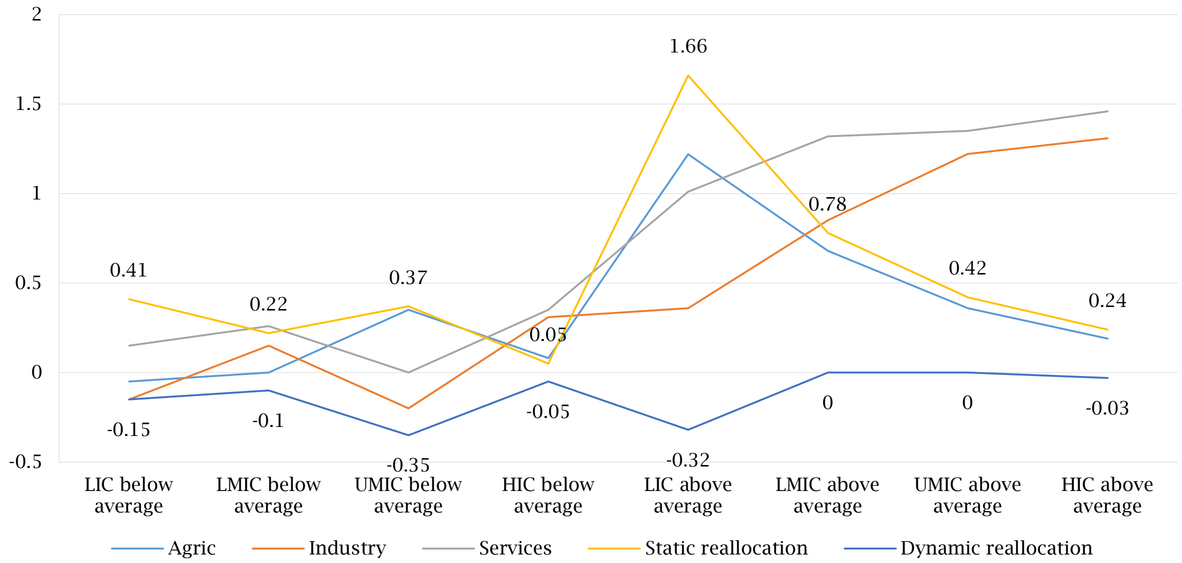
However, recent evidence from 63 countries between 1991 and 2021 (see Figure 3) reveals that static reallocation — shifting labor from agriculture and low-end manufacturing to other sectors-leads to an average annual increase in labor productivity growth of 0.41 and 1.66 percentage points in below-average and above-average low-income countries (LICs), respectively. Although this contribution diminishes as countries progress to higher income levels (see Figure 3), this evidence implies that during the period of economic expansion, LICs should effectively enhance productivity and further shift away from dependence on natural resources and traditional manufacturing sectors such as clothing, textiles, and agriculture towards more efficient sectors like services (see Figure 3).

However, service sectors are usually skill-intensive, while non-tradable services and agriculture are the primary sources of employment in emerging economies. Their lack of productivity in labor is evident in their poor earnings and restricted chances for acquiring knowledge and developing skills (Csáfordi et al., 2020). This challenge requires the government to assist employees in these sectors to be empowered and transition out of their current positions, thereby facilitating the positive effects of structural transformation. However, it should be worth noting that the employment opportunities created by service sectors will only be sufficient for a small proportion of the labor force rather than the majority (Berger & Frey, 2016). Although manufacturing is less productive (see Figure 3), it employs more workers than services. As a result, upgrading the products and services, as well as gradually diversifying the manufacturing base, are both necessary for the transition process. As Figure 4 reveals, in mature industrialized economies, a wide range of commodities and services are normally produced (structural heterogeneity), whereas developing countries are currently involved in a limited number of economic activities that impede their transition.

Developing countries can experience notable advantages from structural transformation due to their development being slowed by structural heterogeneity, which consists of substantial inter-sectoral productivity gaps and a scarcity of high-productivity activities isolated from the rest of the economy (McMillan et al., 2014). As shown in Figure 4, the disparity in productivity is most pronounced in countries with lower income levels. The lack of robust connections between high-productivity and low-productivity sectors diminishes the likelihood of technological advancements and structural transformation. This evidence reveals the importance of diversification, also known as horizontal development of production (Hsu et al., 2021).

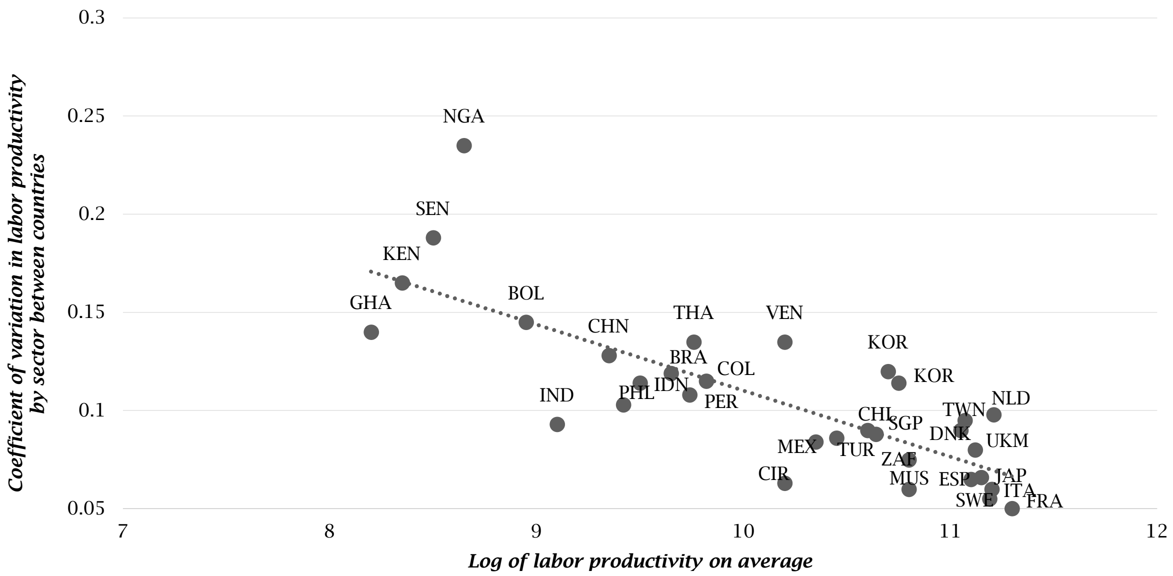
Such structural transformations are capable of producing both static and dynamic advantages. As more workers are employed in sectors with greater productivity, the static gain is the increase in labor productivity across the economy. Progressive enhancements in skill capabilities and positive externalities stemming from employees' access to superior technologies generate dynamic gains that accrue gradually. As a result, more jobs are created that are more formal, higher-paying, and more productive. Long-term economic expansion is thus inherently connected to the increase in productivity within industries and to the process of structural transformation. Socio-economic development can also be achieved through the simultaneous operation of these two forces, ensuring that economic progress consistently facilitates the process of structural change and maintains economic growth.

Figure 4. Components of labor productivity growth (percent) by income group and per capita income growth



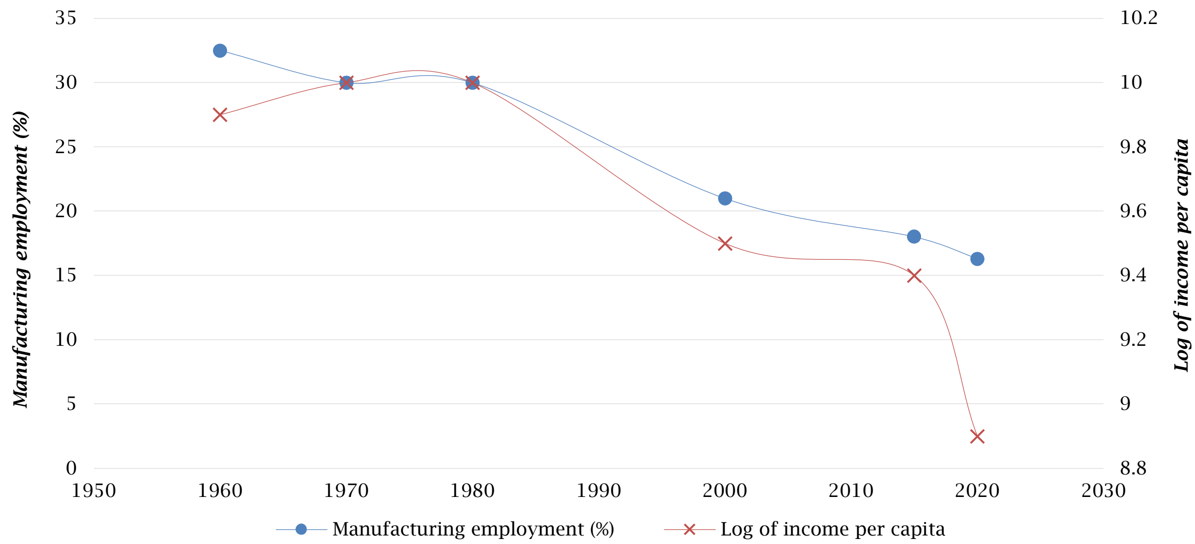
Note: LIC — low-income countries, LMIC — lower medium-income countries, UMIC — upper medium-income countries, HIC — high-income countries.

Figure 5. Relationship between average labor productivity and inter-sectoral productivity gaps



However, at this stage, the transition process becomes more intricate. Once economies surpass a certain threshold of prosperity, they tend to undergo deindustrialization, and manufacturing no longer serves as the primary driver of economic growth (Haraguchi et al., 2017). Deindustrialization can be either positive, which happens in developed economies as a consequence of long-term economic growth, or negative, which happens in economies of all income levels. In the scenario of positive deindustrialization, rapid development in productivity within the manufacturing sector enables companies to meet demand with fewer workers, yet production continues to increase. Displaced workers secure jobs in the services sector as a result of the shift in demand patterns towards services, which is driven by rising incomes and Engel's rule. Consequently, it is anticipated that the proportion of jobs in the service sector will increase while the number of jobs in manufacturing will decrease (Charles et al., 2018). In addition, structural transformation encompasses significant shifts, wherein emerging and leading industries become the primary drivers of job growth and technical advancement, acting as the new catalyst for economic expansion. Positive deindustrialization in that case is an indication of successful economic development, and it is the outcome of industrial dynamism, or productivity development. Conversely, negative deindustrialization results from manufacturing failure. In such instances, a decline in manufacturing production or an increase in manufacturing efficiency leads to unemployment, thus reducing growth (Stiglitz, 2014; Zhu, 2022).

Figure 6. The changes in manufacturing employment and income



Unfortunately, negative deindustrialization seems to happen widely in many countries these days. Developing nations these days often deindustrialize before their wages rise to a sufficient level (Rodrik, 2016). As shown in Figure 6, in the past few decades, the share of manufacturing employment peaked and started to decline at lower levels of per capita income. Several factors could explain this phenomenon. First, advancements in technology lead to a greater reliance on capital in production, reducing the need for labor. This phenomenon is coupled with the increase in globalization and global value chains (GVCs), which allow labor-intensive stages of production to be moved to countries with abundant low-wage labor. As a result, there is an increase in manufacturing employment and output, also known as industrialization. However, many countries have struggled to actively participate in these GVCs. Some governments actively seek new sources of income by exploring untapped natural resources and prioritizing the production of primary commodities over manufactured operations, also called Dutch disease. These countries often replaced policies aimed at achieving a trade surplus in manufacturing with policies that encourage specialization based on low comparative advantages. Consequently, this has resulted in premature deindustrialization.

During the transition process, the government's role is critical. The transition process entails the ongoing enhancement of both physical and virtual infrastructure to align with the requirements of the developing sectors. The constant evolution of this nature necessitates coordination, resulting in significant externalities on transaction costs and returns on capital investment for businesses. It is unreasonable to expect the market to effectively allocate resources in this context. Indeed, developed economies have been able to consistently implement industrial policies to expand their horizons beyond their conventional comparative advantage and venture into novel and more advanced sectors, whereas underdeveloped nations have been unable to undertake such a transition.

Structural transformation should be considered an ongoing process. Throughout the transition process, governments are frequently required to implement two types of policies simultaneously: policies that support structural transformation by fostering the growth of sectors with higher value-added, and policies that attempt to enhance productivity within sectors. The factors that affect whether and how a country changes its production structure are specific to each country. However, in most cases, recent empirical evidence demonstrates that factor endowments and public policies are two key elements that significantly impact the outcome of this process. Instead of squandering money on unpromising industries, it's critical to pinpoint the industrial and service sectors that are actually poised to grow, create high-quality jobs, and drive economic transformation. The sectors that show promise are often characterized by elevated levels and increasing rates of productivity, a comparative advantage, and rising global demand. They also often have significant impacts on GDP and employment, offer advantages in terms of diversification and growth, and attract strong interest from the private sector.

Unfortunately, many countries today aren't ready for further transition (Biloslavo & Friedl, 2009), as evidenced by stagnant structural development (Ortiz, 2013), little productivity change at the company and industry levels (Brea-Solís & Grifell-Tatjé, 2023), significant variations in productivity between sectors and companies (Göbel & Zwick, 2012), and lack of diversification development and sustainable growth (Mania & Rieber, 2019). Because the transition process involves continuously improving both physical and virtual infrastructure to meet the needs of the developing sectors, government engagement is crucial to the unfavorable political economies, characterized by vested interests in maintaining the status quo, which are responsible for the presence of transformation deficits in many developing countries. The government still has shareholdings in most major companies and keeps them as management tools to gain and maintain control over the economy. This is because, in most cases, state ownership of enterprises is not necessarily important for economic intervention but rather is associated with rent-seeking behavior (Parker, 2021). In the early stage of the transition process, the liberalization process does not hurt the rent-seeking elite group overall because they gain more value in a richer industrialized economy than in the dispersed agriculture sector. However, further liberalization that loosens government control will reduce the government's rent, and eventually, they may have no incentive to push through the full transition (Chen, 2008). Indeed, slow progress in the equitization and divestment of state-owned enterprises has been attributable to the reluctance of local management to act. Therefore, the economic transition needs to be facilitated by continuing to build a better constitutional order and rule of law to reduce the rent-seeking problem. Global experience indicates that reaching and maintaining consensus on effective economic policies for transformation is difficult and relies on progressive alterations in the incentives of political and economic players. The most efficient method to make progress is by implementing policy packages that are characterized by both technical expertise and political astuteness.

5. CONCLUSION

Restructuring the economy is vital for numerous developing nations. This paper proposes strategies for the gradual and secure transition of a heavily regulated economy to achieve economic growth. This paper posits that the attainment of macroeconomic settings characterized by fiscal consolidation and low inflation should be prioritized as a foundational step for implementing subsequent reforms. Without macroeconomic stabilization, problems such as inflation and budget deficits could arise and defeat the purpose of reform. The next step is removing distortions in domestic goods, labor, and capital markets, which are very high in highly repressed economies, in order to improve the capability of collecting non-inflation tax to generate revenue for the government. In the fourth step, the government should liberalize international trade to reduce quotas, tariffs, and other administrative controls. The ultimate phase involves the liberalization of the capital account, aiming to diminish and ultimately eradicate limitations on the inflow and outflow of foreign direct investment, portfolio investment, and the utilization of long- and short-term financial instruments. However, opening the economy is not enough to achieve a full economic transition. The findings also reveal that successful structural transformation depends on both horizontal and vertical development and that diversification and technical advancement are critical for maintaining economic growth. In addition, the economic transition needs to be facilitated by continuing to build a better constitutional order and rule of law to reduce rent-seeking, which stops full integration.

However, this study has certain limitations. First, this study neglected to explore the various segmented sections of economic reforms and their possible influence on innovation in developing countries. Second, elements such as the framework, duration, policy implementation, policy combination, funding, and criterion utilization may support diverse perspectives, necessitating additional comprehensive theoretical and empirical investigations in this specific area. Third, the transformation policy must address procedural challenges in addition to the significant organizational role of privatization. Perhaps the necessary economic policy is similar to that of well-established market economies, with the caveat that it is being put into practice under different circumstances throughout the adjustment period. The political system is unstable, the legal and organizational framework is incomplete, the administrative system is flawed, the microeconomic system is still in its early stages, and social and psychological issues arising from a population with limited exposure to a market economy are all hallmarks of the adjustment phase. Because of the enormous magnitude of the necessary structural adjustment and the amount of catching up needed to speed up the economy, the current economic policy concepts designed to address such crises in market economies may not be sufficient. Hence, the conclusions in this paper should be applied with caution, and more research is required.

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