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THE HARE AND TORTOISE: DOES SLOW AND STEADY FINANCIAL LIBERALIZATION WIN THE RACE? A TUNISIAN CASE STUDY

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1. Introduction[1]

As world financial markets become deeply integrated, developing countries are faced with the decision to liberalize their financial sectors and open up their capital accounts, thus encouraging market-based financial systems and international capital flows to move more freely within them.

Economists have long studied the effects of financial liberalization and capital account liberalization on economic growth. From the pioneering work of Schumpeter (1911, in Ghali 1999) on the role of financial intermediaries in economic growth, to the early theoretical work of McKinnon (1973) and Shaw (1973) and to more recent arguments by Levine and King (1993), it has been argued that the development of financial institutions and their ability to reduce information and transaction costs can accelerate productivity gains and thus increase economic growth. Reducing government intervention in the financial sector is said to decrease credit rationing, increase financial sector efficiency and lead to increased savings rates and capital accumulation. Others have argued that international capital mobility within these systems also increases economic efficiency. In similar fashion to the argument for trade liberalization, it is believed that such capital mobility enables a Pareto improving outcome with both participants in developed and in developing countries gaining (Lucas 1990 in Eichengreen 2000). Although causality is sometimes said to be running in both directions, such views claim that financial sector developments can be a driving source of economic development.

Contemporary economic history however also warns us of the possible negative consequences of financial internationalization[2]. The Mexican and East Asian crises are

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two of many recent examples of the potential costs countries may bear when eliminating restrictions on financial institutions and financial flows. After eliminating their restrictions on foreign direct investment, on portfolio investment and on the international operations of domestic banks and firms, Mexico and Thailand suffered from excessive volatility that hampered developmental outcomes.

In the light of these experiences, a new body of literature has emerged on the proper sequencing of reforms in order to reap the prospective benefits of financial internationalization without falling prey to its potential costs. This school of thought stresses that such benefits and costs are not fixed in time. It also posits that financial internationalisation by no means warrants completely free markets. Governments have the responsibility of establishing institutions to monitor and regulate financial activity in order to diminish the probability of economic agents engaging in risky behaviour. As Barry Eichengreen (1998) cleverly points out: "Like a trapeze artist, financial systems can perform miraculous tricks but experience bone-shattering falls if allowed to perform without a net". Although much debate still exists on the subject, most agree that developing countries need to build up these security nets before attempting to reap the benefits of financial institutions, corporations and individuals freely operating in international financial markets.

This paper attempts to add to this literature by making an account of the financial internationalization process in Tunisia. Ever since the mid-1980's, Tunisia has engaged in a program to liberalize gradually its financial and exchange systems by decreasing government intervention in financial institutions and reducing exchange restrictions, controls and quantitative limits on capital transactions. This paper will argue that the

[2] Financial internationalization refers to increased deregulation in two broad policy areas: restrictions over capital account transactions and government intervention on financial institutions (Haggard and Maxfield, 1996).

gradual approach undertaken by Tunisian authorities has enabled them to engage successfully on a road to financial efficiency and avoid the excess volatility that has plagued followers of more rapid approaches to financial deregulation. It will stress the importance of institutional reform implemented before liberalization procedures and advocate that further reforms before establishing the complete convertibility of the Tunisian dinar are needed in order to avoid a repetition of the East Asian syndrome.

The remainder of the paper is organized as follows: It first analyzes why Tunisia engaged in financial liberalization by providing a brief description of the Tunisian financial sector and exchange restrictions prior to its reform program (section 2) and by attempting to explain the political economy factors driving the reform process (section 3). It then looks at how Tunisian authorities engaged in this process through a summary of the literature on sequencing (section 4), an analysis of the steps taken by Tunisian authorities (section 5) and a comparison between them and the more rapid approach taken by Thailand (section 6). The final section concludes with policy prescriptions for Tunisia and discusses the applicability of the paper's arguments in a broader context.

2. Tunisia's pre-reform Financial and Exchange System

In order to analyze Tunisia's financial and exchange system regulations before it engaged in its reform process, one must consider them as part of the country's broader state-led development strategy implemented at independence. Habib Bourguiba, the first president of the newly independent country in March 1956, established massive state intervention and planning throughout the different sectors of the economy.

Opting for such a developmental strategy was coherent with economic development theory of the 1950's and 1960's. At the time, most theories advocated inward-looking development policies in backward countries (Gerschenkron, 1962; Singer, 1964). One can also argue that Tunisian authorities were also persuaded to follow such policies by the political perception of the day as to the success of the Soviet Union's developmental strategy and by the widespread socialist ideology dominant throughout former French colonies (Souayah, 1996). The adoption of such a developmental strategy had the following consequences on exchange and financial system policies.

Foreign Exchange System

In order to adjust their balance of payments, developing countries engaging in such import substituting industrialization strategies frequently used exchange controls to insure that foreign exchange receipts were consistent with external borrowing. In an attempt to shield their domestic economies from international markets, countries would use such controls to suppress domestic demand for foreign exchange (Nsouli, 1996).

Such seems to have been the case in Tunisia following its independence. Although Tunisia wasn't entirely cut-off from external transactions as evinced by its modest export sector, the Tunisian dinar wasn't convertible for current account transactions as defined

by Article VIII of the International Monetary Funds (IMF) Articles of Agreements. This article stipulates: “no member shall, without the approval of the fund, impose restrictions on the making of payments and transfers for current international transactions” (IMF, 1992). These “rules of the game”, agreed upon at the Bretton Woods conference in 1944, were established in an attempt to rebuild the international trading system that had come to a halt during the interwar years (Brett, 1985). But since the establishment of the IMF, developing countries have been unhurried to adhere to this article (Nsouli, 1996).

Tunisia is a good example of such slowness since it only decided to make its dinar convertible for current account transactions in December 1992 (Jaziri, 2001). Although the Tunisian Dinar was on *de facto convertibility*[3] for current account transactions during this pre-reform period, many exchange instruments were used within the broader inward-looking development strategy to isolate its domestic economy. Such instruments included exchange budget restrictions to limit imports and a multiple exchange rate system where the official rate was limited to government current and capital account transactions (Kara and Hleilel, 1996; Nsouli et al., 1993). The Tunisian dinar was inconvertible for capital account transactions as capital controls of the time prohibited inward and outward foreign direct investment and portfolio investment (Nsouli and Rached, 1998).

State Intervention in the Financial System

The state-led development strategy also had pronounced implications on Tunisia’s domestic financial sector. Some argue that the post-independence state had no choice but to take the initiative in organizing production since economic development had been quite modest throughout the French colonial era (Pfeifer, 1996). This was notably the

[3] The concept of de facto convertibility refers to currencies of countries who engage in current account international transactions but that have not met the obligations of the IMF Article VIII, section 2, 3, and 4 (Guitian a, 1996).

case in the financial sector, where most branches of French banks had largely done business with the settler community and left newly independent Tunisia without proper financial institutions (Pfeifer, 1996). The nationalization of foreign-owned business following independence included financial intermediaries, thus making banks the instruments of Tunisian authorities.

These institutions were used to channel credit to sectors that Tunisian authorities deemed most important. Thus the main function of credit institutions was to accumulate savings inexpensively and to direct them to government and public enterprises (Jbili, A. et al., 1997). The Tunisian dinar being inconvertible, Tunisians had no choice but to accept government-determined interest rates that were held artificially low. The banking sector also became highly segmented with the passing of law #67-51 on December 7th 1967 (Jaziri, 2001), aimed at limiting the scope of activities certain types of banks could engage in. State-owned development banks were created to provide medium and long-term subsidized credit to public enterprises while commercial banks were authorized to supply credit to private small and medium enterprises, although most loans had to be approved by the government. This excessive regulation and segmentation of the credit market led to a financial sector with credit rationing and limited competition amongst banks (Jbili, A. et al., 1997).

Inefficiency in Tunisia Financial Sector

Policies undertaken during this period shared various characteristics with similar practices in several East Asian countries at the time. Although South Korea relied more heavily on resource allocation by market mechanisms (Wade in Pfeifer 1999 b), authorities implemented controls over lending and deposit rates as well as extensive credit allocation programs channeling savings towards specific industries. Woo-Cummings (1999) and Putzel (1998) both suggest that such a state-controlled credit-based finance system was one of the main pillars of South Korea's successful

"Developmental State". Such controls over financial markets were key in helping states "govern" their markets by enabling them to exert influence over their domestic investment pattern (Wade, 1990).

Although the 1993 World Bank East Asian Miracle Report acknowledges that financial repression[4] might have helped direct credit to performing industries, it argues that the bureaucracies in countries like Japan and Korea had special characteristics that differentiated them from most developing countries. The report suggested that institutional capabilities in most cases were unable to support performance-based credit allocation programs and that most attempts to implement them in these countries had turned out to be failures (World Bank, 1993). The Tunisian experience with financial repression seems to confirm this belief. Unlike Japan and South Korea, which channeled credit to sectors capable of generating positive externalities, most subsidized lending in Tunisia was allocated to the agricultural sector where technological externalities were unlikely (IMF, 1997). In addition, most of these loans to this sector were made to inefficient state enterprises and were "generally not linked to performance or elements of market contest" (IMF, 1997). Not surprisingly, this inability to allocate credit to viable investments resulted in a dramatic increase in non-performing loans in the state-owned banks' portfolios (Ben Achour, 2001).

As a result, the pre-reform financial system in Tunisia, which was an apparatus of the broader state-led development strategy adopted following independence, could no longer be sustained in the long run. Negative real interest rates indirectly taxing savers, tight exchange controls and inefficient allocation of credit leading to the degradation of the banks' assets sheets all led to low savings rates and stagnant economic growth (Jbili, A. et al., 1997). While some like Karen Pfeifer might argue that financial repression in

[4] The term financial repression refers to the intervention of governments in their domestic financial systems to hold "deposit and lending rates below market clearing levels" (World Bank, 1993).

Tunisia might have been a beneficial policy following its independence, the previous evidence leads one to think that changes were warranted in the new international economic environment of the 1980's.

3. Political Economy Explanations of Tunisia's Financial Reforms.

Although the previous section suggests that changes in the Tunisian financial system were warranted, inefficiencies alone cannot explain the reform agenda set out in the mid-1980s. As attested by political economists, economic policy choices are rarely function of economic efficiency alone, but are more often than not determined by the interaction of different pressure groups in society (Weinhold, 2000). In order to understand the driving forces behind the reform process, this section compares various political economy hypotheses about financial internationalization and tests their validity in the Tunisian context.

Structural and Interest Group Theories

A growing body of literature within the political economy field offers various and sometimes contradictory explanations as to why countries have increasingly liberalized their financial systems and deregulated capital account transactions. Traditional explanations of this trend rely heavily on the role of technological progress. This view, most commonly shared among economists, advocates that advances in communications and information technology have rendered capital controls inefficient and costly (Bryant, 1987). Such capital controls as the ones in place in Tunisia have traditionally been used by governments to access low-cost finance, insure balance of payments equilibrium, retain domestic savings and maintain policy autonomy by enabling domestic interest rates to differ from international ones (Guitian, 1996 b). But it is argued that recent technological innovations making international financial transactions instantaneous and inexpensive have also made it more costly for governments to try to control them (Simmons, 1999).

The use of capital controls is also said to have decreased because of fundamental changes in the international structures of production. The increased number of multinational firms with global configurations and having exit and evasions options are said to have rendered capital controls obsolete. Although evasion of such controls had always been present, this view suggests that the opportunity and incentives to do so increase as a country starts integrating in world trade markets (Goodman and Pauly, 1993). With these arguments in mind, domestic interest group theories, as portrayed by Jeffrey Frieden's specific factors model (Frieden, 1991), explain financial liberalization by the increased pressures of groups standing to gain from such measures. Such groups include liquid asset holders in developing countries, multinational corporations wanting to invest in them and domestic industries not favored by governments' credit allocation schemes. This is argued to have been the case in Japan's shift from its state-credit allocation scheme to a more market-based allocation scheme in the early 1980s (Calder, 1997). Japanese commercial banks and securities firms, as well as Japanese corporations wanting to raise funds more cheaply and to take advantage of services previously not offered in their domestic financial market, are all believed to have played a key role in pressuring the conservative government to enact the Foreign Exchange and Trade Control Law of December 1980 (Calder, 1997). This new law relaxed foreign exchange controls and restrictions on banking activity.

Others have transposed such interest group theories to the international level. These analysts have held that the pressure of countries with strong interest in the liberalization of external controls is key to an understanding of the recent trend toward capital account liberalization. The emergence of neo-liberal ideology in industrialized countries and in international financial organizations, especially with the Reagan and Thatcher administrations, is said to have provided a clear framework for countries to follow (Helleiner, 1994 in Cohen, 1996). In what comes close to resembling a conspiracy

theory, these institutions and western financial corporations are said to have bullied countries into abolishing their foreign exchange restrictions (Wade and Veneroso, 1998).

Although these various explanations of financial internationalization might explain the worldwide trend towards capital account liberalization in the last decades, one could argue that they do not explain the timing of such reforms by Tunisian authorities in the mid-1980s. Unlike East Asian countries like Japan, Tunisia's productive capacity at the time was concentrated in the hands of government authorities. Although Tunisia had attempted to denationalize industrial production in the early 1970's with the passing of the "intifah"[5], private sector activity had remained minimal and public sector activity still represented 60% of manufacturing output in 1981 (Richards and Waterbury, 1998). One could thus argue that the domestic pressure for financial deregulation and capital account liberalization was not as persuasive in the Tunisian context. One could also argue that external pressures by powerful financial corporations are unlikely to be the cause of the Tunisian reform process: The relatively small size of its domestic market did not make it a major target of international financial interests.

Economic Crisis as Cause of the Policy Shift

Although previous theories might explain why capital controls have been gradually harder to maintain in Tunisia, one must analyze the steps taken by Tunisian authorities in their social and economic environment during this period. As the following arguments will show, Tunisia's decision to deregulate its domestic financial sector and open it up to international capital flows was not a policy choice per se, but a consequence of its broader shift in developmental strategy.

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[5] Arabic term meaning opening up. This type of economic and political liberalization policies are better known from Anwar Al-Sadat's Egypt (Richards and Waterbury, 1988).

The delay of the reform process seems consistent with Dani Rodrik's (1998) claim that trade reform and broader developmental strategy changes incur great redistribution costs. Tunisia's inefficient inward-looking developmental strategy discussed in the previous section can be argued to have been kept in place because of the high political cost-benefit ratio of the proposed reforms. Political hurdles stood in the way of change in Tunisia, as economic and political logics conflicted (Richards and Waterbury, 1998).

Rodrik suggests that broad economic reforms are more likely to be undertaken when this political cost-benefit ratio is decreased, such as in time of economic crisis or regime change. Economic crises are said to enable governments to undertake reform whilst opposition is disorganized and regime change is believed to give new leaders a grace period to implement such reforms (Rodrik, 1994).

Tunisia went through both in the mid-eighties. External shocks repeatedly hit its economy throughout the beginning of the eighties. The international recession of the early 1980s and increasing protectionism from European trade partners decreased demand for its exports and its ability to accumulate foreign exchange (Richards and Waterbury, 1998). On the supply side, Tunisia had to cope with declining oil reserves and production in addition to the decrease in oil prices following the second oil shock, severely reducing the government's revenues (Nsouli et al., 1993). Attempts by the Tunisian government to address its deficit problems by trying to cut back on consumer-subsidy programs failed in January 1984 because of public discontent and riots against such measures[6]. By mid-1986, the status quo was no longer sustainable. Tunisia's international reserves had dwindled down to a few days of imports, the debt had increased to 63% of GDP and the debt service ratio had augmented to 28% of current

[6] *Les révoltes du pain* consisted of riots against cutbacks in state subsidies of basic food products, notably bread.

receipts (up from 38% and 14% respectively in 1981) (Nsouli et al., 1993). As argued by the previous Deputy Governor of the Tunisian Central Bank:

> The government hesitated to take the unpopular reforms necessary… It takes special circumstances, notably external payment crises, for governments to recognize that it has no alternative but to rehabilitate the national economy (Souayah, 1996).

In the light of Rodrik's argument, regime change in 1987 can also be seen as crucial to Tunisia's road to reform in the mid-eighties. In a coup that threw out Tunisia's only president since its independence, Zayn al-Abdine Ben Ali took over as president on November 7th 1987. Although sometimes attributed to the Islamic threat against the state under Bourguiba's rule, economic difficulties were a driving factor of this political change and its recognition by Tunisians (Brand, 1998). Under Ben Ali, Tunisia embarked on a wide-ranging shift in developmental policy. The inward looking industrialization strategy was to be slowly replaced by a more export-oriented one, with greater reliance on market forces and international markets (Tekaya, 2001).

Consistent with Rodrik's claims, Stephan Haggard and Sylvia Maxfield explain more specifically why developing countries have recently engaged in financial internationalization. Although they agree that systemic pressures coming from increased integration within the world economy constrain governments' policy decisions, they argue that most instances of liberalization of developing countries' financial systems happen in balance of payments crises (Haggard and Maxfield, 1996). Although conventional wisdom posits that such crises will lead countries to re-enforce capital controls in order to limit capital flight, analysis of IMF data has led them to suggest that the opposite seemed to be the case throughout the 1980s and 1990s. Balance of payments crises are believed to empower economic agents that hold or generate foreign exchange and favor financial deregulation. These include the export sector, private foreign

creditors and investors, foreign financial intermediaries and multilateral financial institutions[7] (Haggard and Maxfield, 1996). Governments are said to react to pressure from these groups to liberalize capital account transactions in a bid to increase the credibility of their future policy decisions and resume capital inflows (Bartolini and Drazen, 1997). In order to do so, governments have also often initiated institutional change to make further reversals more difficult.

Tunisian financial reforms initiated in the aftermath of the balance of payments crisis are consistent with this interpretation. Not only did Tunisia actively start deregulating capital account transactions in order to attain balance of payments equilibrium, but it also engaged in institutional reforms that had as their main purpose the delegation of economic policy-making to independent bodies with economic priorities instead of political ones. As seen in the aftermath of the crisis, President Ben Ali has noticeably supported the opinions of his skilled technocrats by placing them in charge of most economic policy decisions (Richards and Waterbury, 1998).

[7] The fact that international financial institutions have more influence on government policy decisions during crises could be compatible with arguments by Helleiner (1994) and Wade and Veneroso (1998).

4. Capital Account Liberalization and Sequencing

As seen in the previous section, Tunisia engaged in its financial and exchange system reforms in the aftermath of its mid-1980s economic crisis. Such policy shifts have been theoretically praised for their potential beneficial effects on the economy and at the same time criticized for generating excessive volatility. This section analyzes the potential benefits and costs of Tunisia's financial sector reform process and argues that its result can be conceived as a function of the sequencing of its execution.

The Benefits and Costs of Capital Account Liberalization

The normal assumption of neoclassical economists being that markets know how to allocate resources better than governments, they have long questioned why states should be involved in heavily restricting the freedom of economic agents wanting to engage in international financial transactions. By making a parallel to free trade of goods and services, most previously believed that the same would be true for capital account liberalization.

Proponents often point out the fact liberalizing capital flows enable financial resources to get the highest return possible as international capital flows transfer resources from high saving countries to low saving ones. This argument has lead many economists to believe that open financial markets are welfare enhancing for they can be an important source of funding for investment projects as developing countries can tap savings globally (Summers, 2000). This can be thought of as being especially relevant in Middle Eastern countries given their historically low domestic savings rate (Wade in Pfeifer, 1996). One could thus argue that the case for capital account liberalization was stronger in Tunisia than it was in Asian countries, which were characterized with high domestic savings rates.

Others point out that capital account liberalization can force countries like Tunisia to put into place a stable and attractive economic environment. Since investors respond negatively to lax government policy, the threat of them withdrawing their capital at any time could have forced Tunisian authorities to follow prudent macroeconomic policy (Feldstein, 2000).

But anybody reading a newspaper in late 1997 had no difficulty in seeing the potential costs of excessive capital mobility. Civil strife and protests were common sights in Asia, as the poor, who endured a disproportionate burden in terms of increased unemployment, could not cope with the consequences of enormous capital outflows on the real economy. As a recent paper from the Oxford International Development Centre explains, this sudden reversal had damaging consequences for Asia's real economy by affecting production levels, investment, real wages and social services provided to citizens (FitzGerald, 2000). Some would thus argue that short-term capital flows are deemed to have substantial negative externalities and that countries like Tunisia should think twice before opening up (Stiglitz, 2000). The Asian crisis makes it obvious that financial volatility affects more than just lenders and borrowers.

Proper Sequencing of Financial Internationalization

As has been briefly summarized, these crises have ignited a fervent debate on the cost and benefits of domestic financial system and capital account liberalization. The first view holds that countries should liberalize or be prepared to fall to the bottom of the Penn World Tables (Eichengreen, 2000). The second view, as articulated by Malaysian Prime Minister Mahathir Mohamad, claims that global markets act like "a jungle of ferocious beasts" and thus that the costs of opening a country to capital flows far outweigh the benefits (The Economist, 1998).

The body of literature on the proper sequencing of financial internationalisation argues that both views are missing the point. This literature points out that, contrarily to the previous dichotomist debate between its benefits and its costs, financial internationalization "is not an all or nothing affair" (Johnson, 1998). Like Tunisia, several developing countries have recently engaged in opening their financial systems by liberalizing carefully selected capital transactions at different periods of their reform process.

History has also taught us that the benefits and costs of capital account liberalization are not fixed in time. Over the past century, most industrialized countries have, slowly and painfully, developed an ensemble of various institutions to cope with market failures and insure greater stability. Before implementing such institutions as the Federal Reserve System, the Federal Deposit Insurance Corporation, modern bankruptcy laws and more effective judicial systems, the United States fell prey to many crises similar to the ones hitting developing countries financial markets today (Radelet & Sachs, 1999). The Savings and Loan debacle and the collapse of the Long Term Capital Management hedge fund during the Asian Crisis are reminders that these institutions are far from perfect. If developed countries are still exposed to instability in international financial markets, it is reasonable to think that developing countries like Tunisia would be even more.

Much debate however still exists about the proper sequencing to attain capital account convertibility. Gradual approach theories stress that current account liberalization and reform of the domestic financial systems should be prerequisites for capital account liberalization (Edwards, 2001; McKinnon, 1991). This view stresses that the beneficial impact of such liberalization measures is positively correlated with the development and efficiency of domestic financial systems (Johnson, 1998). It thus promotes a gradual process where countries only deregulate various international financial flows once the appropriate institutional frameworks to regulate them are in place.

Others such as Krueger and Michaely have argued for simultaneous and more rapid liberalization of current and capital accounts (Krueger 1984, Michaely 1986 in Johnson et al., 1997). Although it recognizes that the maintenance of capital controls have been extolled because they are said to provide time for countries to meet the prerequisites of external financial liberalization, this view argues that the delay in waiting for such conditions to materialize is "the best recipe for the permanence of capital controls" (Guitian, 1996 b). The supporters of this "big bang" approach believe that liberalizing capital accounts sooner than later will force domestic authorities to engage in the necessary reforms to insure stability whilst enjoying the benefits of accrued growth. Some even argue that efficient domestic financial intermediation can be seen as an outcome instead of a prerequisite of capital account liberalization (Guitian, 1996 b).

The sequencing of reforms to financial systems and to restrictions on capital account transactions is thus still a matter of debate. This derives from the complex nature of such sequencing and the multiple variables that make case-by-case studies more relevant than broad and generalized conclusions (Johnson et al., 1997). The analysis of the Tunisian approach and its comparison to Thailand's case in the following sections doesn't claim to advocate the supremacy of an approach over another. In theory, such an optimal approach can be defined as the one "finding the adjustment trajectory that will maximize the intertemporal welfare function subject to various financial and structural constraints" (Nsouli, 1996). Instead, it will be argued that, within its initial conditions described in previous sections and its broader economic objectives, Tunisia's gradual approach enabled it to engage in welfare enhancing reform without having to deal with excessive volatility. Accelerated approaches, of the kind pursued by Thai authorities, will be argued to breed destructive instability.

5. Tunisia's Gradual Approach to Financial Internationalization.

As previously argued, Tunisia's slow and steady policy shift towards capital account convertibility must not be seen as a policy choice on its own, but as part of its broader shift towards engaging in an export-led development strategy.

Deregulation of Foreign Direct Investment

The liberalization of foreign direct investment was part of wider real sector reforms aimed at strengthening Tunisia's export potential. This strategy led Tunisian authorities to authorize and actively attract foreign direct investment in various sectors of its economy in order to correct external accounts disequilibria (Tekaya, 2001). Proponents of gradual sequencing have stressed the need to liberalize this type of capital flow first. It is believed that foreign direct investment is less likely to aggravate or expose weaknesses in domestic financial systems because of the fact that it cannot easily be quickly withdrawn in the event of creditor panic (Eichengreen, 1998). In addition to being "bolted" down, such foreign direct investment can be valuable for countries like Tunisia for it also offers the possibility of introducing new technology, access to markets and possible improvement in human capital through valuable training (Wade in Pfeifer, 1999). It can also be argued that this positive impact was even stronger in Tunisia because of its high endowment in human capital, as portrayed by its ranking as "the best African country for the quality of its human resources" by the 2000 report on competitiveness in Africa conducted by the World Economic Forum (Tunisia, 2001 d). Papers have indeed suggested that these beneficial effects of foreign direct investment are more likely to be found in countries with high levels of education, which helps such countries absorb new technologies more quickly (Borensztein et al. 1998 in Loungani and Razin, 2001).

In order to spur foreign exchange receipts, Tunisian authorities have gradually liberalized foreign direct investment in an increasing number of export industries. Enacted in December 1993, the Tunisian investment incentives code (law #93-120) currently allows foreigners to have, without prior authorization, full ownership of capital in fully-exporting sectors. Such sectors include tourism and manufacturing industries targeting international markets, such as textiles, garments and automotive, electric and electronic components (Tunisia, 1996).

To attract foreign investors, Tunisian authorities not only gave tax incentives to foreigners but also eliminated various foreign exchange controls and liberalized various capital account transactions (Jaziri, 2001). These developments have enabled foreign investors to repatriate their profits and liquidate their capital in the event of the sale of their assets (Nsouli, 1993).

Domestic Financial Sector Reform

The liberalization of capital account transactions in the form of foreign direct investment was not matched by similar measures for footloose capital. Tunisian authorities have viewed short-term capital inflows as "bad cholesterol", compared to the "good cholesterol" nature of foreign direct investment (Hausmann and Fernandez-Arias, 2000 in Loungani and Razin, 2001). They have been skeptical of the high volatility of such capital inflows and have thus been reticent to liberalize them (IMF, 2001 a).

In accordance with supporters of the gradual approach, it was believed that liberalizing such inflows should not precede the strengthening of Tunisia's domestic financial system (UNCTAD, 1999). Reforms set out in the late 1980s and the new banking Act #94-25, targeted the banking sector because of its essential role in the Tunisian economy (Tunisia, 2001 b). The first measure taken by Tunisian authorities was gradually to liberalize

interests rates. In order to do so, they set out to eliminate the numerous restrictions and regulation they had previously put on banks. In 1988, Tunisian authorities abolished the requirement that the Central Bank authorize commercial bank loans (Jbili et al., 1997). Circular[8] #94-08, enacted in June 1994, was aimed at liberalizing bank lending by allowing commercial banks to fix freely interests rates on loans to non-priority sectors (Tunisia, 2001 b). Preferential interest rates to priority sectors were also abolished in November 1996 with Circular #96-15 (Tunisia, 2001 b).

Tunisian authorities also moved to a more market-based way of financing government deficits. Prior to reforms, the government financed its deficits by requiring banks to hold government paper (IMF, 1996). In September 1989, Circular #89-29 eliminated such requirements and forced government deficits to be financed at market conditions by issuing treasury bills (Tunisia, 2001 b). Such measures reducing government intervention in banks brought about a gradual disappearance of government credit allocation and allowed banks greater freedom in their lending activities (IMF, 1997).

Such freedom does not however call for the complete withdrawal of government intervention in financial markets. Theories on gradual sequencing of capital account liberalization advocate the importance of strengthening government supervision of the financial system and establishing prudential regulation measures to insure financial stability (Mishkin, 2001). This prerequisite derives from the belief that risk management practices are lacking in emerging markets' banks, for they have not been previously exposed to market conditions (Eichengreen, 1999). It is thus suggested that banks become more efficient in allocating resources to profitable investments and that the state impose prudential regulation on their activities before allowing them to expand their asset and liability sheets, domestically or internationally.

[8] Name given by the Tunisian Central Bank to laws concerning banking sector activities.

Reforms aimed at the Tunisian banking sector have addressed these issues with the implementation of a World Bank-sponsored banking sector restructuring program in 1999. The main objectives of the Economic Competitiveness Adjustment Loan (ECAL) were to address the chronic bad debt problem in Tunisian banks and strengthen the banking system's regulatory and prudential supervision framework (IMF, 1999 b, Box 2). This program has enabled the settlement of non-performing loans to public enterprises by writing them off the banks balance sheets and the settlement of private sector bad loans by enabling the establishment of private debt resolution companies (Sfar, 2001). In order to avoid the resurgence of the problem, the Tunisian Central Bank has also enacted Circular #2001-04 obliging banks to adhere to the Basle Accord on international convergence of capital measures and capital standards (Tunisia, 2001 b). To reinforce confidence in its banking sector, this accord obliges banks to hold a minimum capital stock of at least 8% of risk-weighted assets (Kapstein, 1994). This restructuring program has had promising results on Tunisia's banking sector, as seen by the increase in the capital adequacy ratio of Tunisian commercial banks from 5,1% in 1996 to 12,4% in 2000 (Sfar, 2001) and by the decrease in the level of un-provisioned bad loans from 18,4% in 1997 to 14,1% in 2000 (IMF, 2001 a).

Barry Eichengreen (2000) also suggests that enabling entry of international banks in the domestic market can foster increased risk-management capabilities. It is believed that, as is the case with foreign direct investment in general, foreign banks can introduce efficient practices in the domestic banking sector. In the light of this argument, authorization was given by the central bank to let targeted international banks establish subsidiaries in Tunisia. Such banks, as is the case for Citibank's subsidiary in Tunis, "have been allowed to enter Tunisia's domestic banking market in the hope of them transferring valuable know-how, new technology and enabling an increase in service quality" (Sfar, 2001).

As is the case in most developing countries, Tunisia's pre-reform financial sector also relied disproportionably on banks. Given the government participation in banks[9] and the resulting imperfect competition in the banking sector, it is argued that another way of increasing competition in the financial system, besides liberalizing entry in the banking industry, was to develop other financial institutions capable of competing with banks (Sfar, 2001). Malcolm Knight (1998) suggests that other markets and institutions in developing countries, such as stock and equity markets, can increase competitiveness and the robustness of financial systems if they are well regulated. By offering alternatives to depositing savings into a bank account, such institutions are said to limit the capability of banks to raise intermediation spreads by lowering deposit rates (Knight, 1998). Although Tunisia had officially established its stock market in 1969, it was largely inactive until the government introduced a plan to restructure it in 1994 (Jbili et al., 1997). Enacted in November 1994 and fully implemented in 1995, this reform program fully privatized the stock exchange[10] and created two separate entities: a clearing house[11] and a regulative body to supervise the activity of the market[12] (IMF, 1996). In order to insure greater efficiency and transaction security, it has also recently introduced a central body to modernize its payments system and, with the help of the French Government, the same electronic quotation system as the one used in the Paris stock exchange (Ben Achour, 2001).

Gradual Decrease of Capital Controls

Although sometimes criticized for being too slow, the process undertaken by Tunisian authorities towards capital account liberalization has tried to maintain its objective of

[9] One out of two deposit money banks was state-run in 1996. These public banks accounted for 68% of commercial bank loans in 1994 (IMF, 1997).
[10] Bourse des Valeurs Mobilières de Tunis (BVMT).
[11] Société de Dépôts, de Compensation et de Règlement des Titres.
[12] Conseil du Marché Financier (CMF)

providing the necessary exchange freedom to enable enterprises to compete successfully on domestic and international markets (IMF, 2001 c). Unlike Thailand that aspired to become a regional financial center, Tunisia's stated goal was to respond to business demands to facilitate their operations in the new international economic environment (Sfar, 2001).

It is in this perspective that capital controls have gradually been decreased to enable enterprises to cover their commercial foreign exchange exposure. As mentioned previously, steps were taken in 1992 to insure current account convertibility as defined by Article IV of the IMF Articles of Agreement and in 1993 to allow foreign direct investment and permit foreign investors to repatriate their profits. As for resident enterprises, Tunisian authorities have increased amounts allowed to be borrowed abroad and increased ceilings on foreign exchange deposits that these enterprises are allowed to hold. Such ceilings are said to have been carefully studied and were determined in the light of their needs (Jaziri, 2001). Circular #2001-11 enabled resident enterprises to deposit 50% (up to 100% with authorization) of their foreign exchange receipts and to cover themselves against foreign exchange risk by creating a forward exchange market allowing them to buy 3, 6 and 12 month options (Tunisia, 2001 c).

Despite the relaxation of capital controls for enterprises dealing in international markets, most controls on individuals residing in Tunisia have been maintained. Although full capital account convertibility is a long-term goal for Tunisian authorities (Sfar, 2001), many restrictions on capital account transactions remain in place, as can be seen in Table 1.

Table 1: Controls on Current and Capital Transactions in Tunisia

Type of Transaction	Existence of Controls	Specifications
Current Account Transaction	No	Free transfer of currency for trade transactions as defined by the article VIII of the IMF Status (as of January 6, 1993).
Foreign Direct Investment		
Inward	No	Law #93-120 gives freedom to invest in exporting sectors. Foreign investment in other than fully exporting sectors is subject authorization when foreign equity exceeds 50%.
Outward	Yes	Circular #94-09 enables resident enterprises to invest abroad to support their exporting activities for an amount up to TD200 thousand per year.
Repatriation of Profits	No	Law #93-120 allows non-residents having invested in Tunisia to freely repatriate their profits or the proceeds coming from the liquidation of their invested assets.
Capital Market Equity		
Purchased locally by non-residents.	Yes	Circular #98-02 limits foreign participation in Tunisian companies listed or not on the Tunis stock market to 50% of total equity shares with voting rights.
Purchase abroad by residents	Yes	Exchange law #94-41 severely limits the amounts residents can exchange in order to purchase capital market equity abroad.
Credit Operations		
Commercial Credit for residents: ▪ Inflow	Yes	Circular #93-16 permits resident enterprises to annually borrow abroad up to a maximum of TD10 million for financial institutions and TD3 million for other enterprises
▪ Outflow	Yes	Various controls on lending abroad are still in place.
Deposit Accounts		
Non-residents in foreign exchange	No	Exchange note #94-1 and circular #94-13 enables foreigners to open accounts in foreign currency or convertible dinars (i.e. that can be reconverted into foreign currency).
Non-residents in local currency	No	
Residents abroad	Yes	Law #94-41 obliges residents to repatriate and sell foreign currencies that are earned abroad unless otherwise specified by the Central Bank of Tunisia.

Note: As of July 2nd, 2001, 1 Pound Sterling = 2.0260 Tunisian Dinar.

Sources: Central Bank of Tunisia, Tunisian Ministry of International Cooperation and Foreign Investment, Nsouli and Rached (1998).

6. Big Bang Approaches to Financial Internationalization.

Tunisia's gradual approach to financial sector reforms and capital account liberalization can be contrasted with the more rapid pace adopted by Thai authorities from 1985 to the onset of its financial crisis in 1997. As stated previously, there are theoretical arguments that suggest that swift liberalization can be an optimal policy choice. They argue that rapid capital account liberalization can foster momentum for the execution of such processes by weakening entrenched vested interests desiring the maintenance of capital controls. This view states that waiting for the prerequisites to be in place before liberalizing international financial flows can be harmful, for these conditions are more than likely never to be reached (Guitian, 1996 b). It holds that rapid financial internationalization can thus be beneficial if such processes are accompanied by fast-paced reform to the domestic financial system (Johnson et. al., 1997). But as Malcolm Knight (1998) suggests, this section argues that countries with banking weaknesses cannot be expected to build efficient financial systems capable of dealing with increased capital inflows overnight. This case study of the Thai experience of rapid financial liberalization is thus provided to outline the dangers of this approach compared to the more gradual one pursued by Tunisian authorities.

Foreign Direct Investment

In contrast to Tunisia's case, Thailand's financial system could already have been considered relatively open before the further liberalization program of the mid-1980's (Lauridsen, 1998). Thailand had first engaged in liberalizing foreign direct investment for import-competing industries in the 1970's and for export industries in the 1980's (Eichengreen, 1998). Unlike Tunisia's reform process, liberalization in Thailand enacted under the Alien Business Law of 1972 and the Investment Promotion act of 1977 also treated portfolio investment fairly liberally, for domestic enterprises were allowed to borrow freely overseas as long as loans were registered with the Bank of Thailand (Johnson et al., 1997).

In a balance-of-payment crisis similar to that which hit Tunisia and most developing countries in the mid-1980s, Thailand undertook a stabilization program from 1984 through 1987. Although structural adjustment policies were minimal due to its already fairly liberalized economy, macroeconomic stabilization policies, such as the 15% devaluation of the Thai baht and tighter fiscal and monetary policy, led to an export-led economic boom and a rapid re-adjustment of external payments (Alba et. al., 1999). This large devaluation combined with greater efforts by Thai authorities to attract foreign investors also led to a substantial increase in foreign direct investment (Lauridsen, 1998). Similar to actions taken by Tunisian authorities, these efforts consisted of the elimination of restrictions on foreign direct investment in various sectors, tax incentives to attract foreign companies and the adoption, in 1990, of Article VIII of the IMF's Articles of Agreement officially establishing the current account convertibility of the baht (Alba et al., 1999). One could thus argue that policies taken by Thailand concerning foreign direct investment were similar to the ones followed by Tunisian authorities, albeit a few years later in the latter.

Elimination of Capital Controls: Thailand's Claim to Become a Regional Financial Center

The main difference with Tunisia's gradual process has been the treatment of portfolio investment by Thai authorities, especially after reforms undertaken in the early 1990s. Policy decisions regulating these flows have been repeatedly pointed out by academics and policy-advisors as being at the root of Thailand's financial crisis.

Unlike Tunisia's reform process, the interim government of Anand Panyarachun, in power in the early 1990s, hastily abolished various existing exchange controls in a bid to develop Thailand into a regional financial center (Hamann, 1999). In only thirteen months in power, the first Anand government enacted twenty financial and exchange system reform bills (Doner and Unger 1993 in Lauridsen, 1998). These bills liberalized foreign exchange transactions for capital account transactions, reduced commercial

banks' capital reserve requirements, decreased regulation on the activity of non-bank institutions and greatly expanded the activities that banks and financial institutions could engage in (Alba et al., 1999).

In addition to these bills, the Anand government actively promoted the establishment of the Bangkok International Banking Facility (BIBF). Created in 1993, the BIBF had as its main goal to increase the scope of international banking in Thailand by enabling Thai banks with a BIBF license to borrow abroad more easily (Hamann, 1999). Not only did it facilitate foreign borrowing, but Thai authorities also gave extra incentives to Thai banks to do so by offering them generous tax advantages (Eichengreen, 1998).

These policies, in combination with the Thai government's pledge to maintain its fixed exchange rate, drastically increased private borrowing by banks and firms. Thailand's private external debt subsequently doubled in only three years, rising from US$37,1 billion in 1993 to US$73,8 billion in 1996 (Bank of Thailand in Alba et al., 1999). Moreover, a growing percentage of these loans were short-term in nature (Johnson et al., 1997) and un-hedged against currency variation risk (Lauridsen, 1998).

Contrarily to Tunisian authorities that maintained exchange controls before making efforts to reform its domestic financial system and implement prudential regulations, Stilgitz (1998) argues that this excessively rapid capital account liberalization in Thailand was undertaken without the prior establishment of a proper precautionary framework. Despite various attempts to apply proper supervision and prudential measures, the failure to implement them properly due to the opposition of powerful financial sector interests brought vulnerability to the financial system. In the aftermath of its previous financial crisis in 1983, Thailand had amended its 1979 Commercial Banking Act in 1985 in an attempt to put into practice tougher measures in order to insure that such crises would not happen again. But Naris Chaiyasoot argues that during the late 1980s export-boom that quickly followed the financial crisis, "the main focus of government policy (…) was not on control and regulation, but rather on deregulation and competition" (Naris, 1995 in

Lauridsen, 1998). Further attempts to regulate the banking activity in the light of the excessive capital inflows in the beginning of the 1990s were also in vain. Attempts by the Bank of Thailand to force Thai banks to adhere to Basle Accord regulations on capital adequacy and to reform loan classification and loan loss provisions were not successful (Alba et al., 1999). In addition, warnings by technocrats about the dangers of the pegged currency were also ignored (Lauridsen, 1998).

The mix of inadequate prudential regulation and massive capital inflows turned out to be lethal. The fact that Thai banks were financing domestic projects with long-term expected returns and were borrowing short-term on international financial markets quickly rendered the banking system vulnerable to shocks. As many papers have shown, the loss of confidence in the Thai economy by foreign investors and the subsequent massive outflows of capital had drastic consequences on the real economy[13].

Contrary to Guitian's claims that rapid capital account liberalization pushes government to engage in rapid financial sector reform, the inability of Thai authorities to implement proper safeguards is additional evidence supporting the view that developing countries cannot be pressured into building effective and stable financial systems overnight. Instead of eliminating interest group pressures in favor of capital controls, this rapid process in Thailand created politically powerful groups that had no interest in the governments attempts to curb their risky, short-term profit-making, behavior.

Shift in Developmental Strategy

Others have argued that inefficient prudential regulation of banks cannot, on its own, explain the gravity of the crisis that hit late in 1997. The financial debacle that hit Thailand is believed to have been comparable to the severity of depressions hitting the western world in the 1930s (Wade and Veneroso, 1998). These analysts argue that the inefficiency of prudential regulation of Thai banks didn't mandate such a steep fall, making them believe that the "punishment was much worse than the crime" that Thai

[13] Fitzgerald (1998) renders an account of the effects of these outflows on the real economy.

authorities had committed by not properly regulating the banking sector (Radelet and Sachs, 1999). Such arguments rely upon facts such as ratings of Thai banks in 1996 by Moody's Investor Services not indicating that they were substantially worse than in countries which were not as badly hit by the crisis (Bosworth 1998, in Radelet and Sachs, 1999). In addition, spreads between Thai debt and risk-free U.S. Treasury securities, a measure of the perceived risk of collapse, were on a downward trend as late as in the beginning of 1997 (Stiglitz, 1998).

Instead of being the fundamental cause of the crisis, excessively rapid capital account liberalization with unsound banking systems is argued to have been the result of an implicit new developmental strategy aimed at having foreign capital as the main motor of development (Putzel, 1998). The Thai authorities' stubborn commitment to its pegged exchange rate, even after having been warned about the dangers of such a policy stance by technocrats within the Ministry of Finance, is evidence of the dependence of the Thai economy on foreign capital inflows and for this previous claim.

Within such strategy, one could argue that whatever prudential regulation might have been in place would not have stopped misallocation of resources to unsound projects. As Wade (2000) argues, the effectiveness of prudential regulation can be conceived as a function of the amount of inflows into a country's financial system. In addition, even with sound banking practices, one could argue that private corporations could have directly accessed world capital markets, as was notably the case in Indonesia (Stiglitz, 1998).

These arguments have led many academics and policy-makers, albeit not inside the IMF, not only to advocate gradual capital account liberalization within efficient banking systems and regulatory frameworks, but also to avoid excessive reliance on international financial markets because of herd behavior of foreign investors and their disposition to create self-fulfilling attacks and runs on currencies. As Stiglitz (1998) shrewdly summarizes: "Small open economies are like rowboats on a wild open sea (…). The

chances of eventually being broadsided by a large wave are significant no matter how well the boat is steered”.

7. Policy Conclusions

Although by no means does the previous comparison advocate an optimal sequencing of measures that countries wishing to liberalize their financial systems should follow, it adds additional evidence that gradual liberalization can foster financial efficiency whilst avoiding excessive fluctuations. The Tunisian liberalization has spurred higher real returns on savings, greater efficiency of its financial system and increased its savings rate (Jbili et al., 1997).

Policy Conclusions in the Tunisian Context

As stated previously, Tunisian authorities have set a long-term goal of achieving complete convertibility of the Tunisian dinar, as much for current account transactions as for capital account transactions (Sfar, 2001). In the opinion of most analysts at the IMF, the achievement of this target can be welfare enhancing. As is the case with their analysis of the East-Asian crisis, they advocate that capital account liberalization has been improperly described as being the main cause of recent financial crises. They rather stress the importance of improper policy decisions, inappropriate incentives created by authorities and the sequencing in which these processes were done (Nsouli and Rached, 1998). Although some convincingly argue against this belief by suggesting that East Asia's successful high debt model was not compatible with capital account liberalization, previous sections of this paper have tried to show that Tunisia's pre-reform financial system could not be compared to the ones found in these "Development States". One can thus argue that gradual capital account liberalization can be a beneficial policy stance once Tunisian authorities put the proper prerequisites in place.

Macroeconomic Stability

The 1994 Mexican Crisis is only one example of the dangers of allowing free circulation of capital flows in the absence of sound macroeconomic policy, such as prudent exchange rate management and balance of payments equilibrium (Edwards, 1998). Recent IMF

Article IV Consultation reports[14] on Tunisia's economic perspectives suggest that its authorities have tackled these issues. These reports claim that the gradual liberalization process of various sectors of its economy and prudent macroeconomic policies have allowed Tunisia to benefit from its increasing integration into the world economy (IMF, 2001 a).

Policies undertaken by its technocrats have ensured a real growth average of 5.7% in the last five years, kept inflation stable at just under 3% and have constantly decreased budget deficits in proportion to GDP, falling to 3.7% of GDP in 2000 (IMF, 2001 c). Tunisian authorities have also been praised for implementing a responsible exchange rate policy. Based on a basket of export competing countries' currencies, the managed-floating exchange rate policy has played a pivotal role in insuring price competitiveness of Tunisian exports (Tunisia, 2001 a). Contrarily to Thailand's stubborn refusal to deviate from its peg preceding its crisis, Tunisian authorities moved away from its exchange rate rule by allowing the dinar to depreciate in the light of the weakening euro in 2000 (IMF, 2001 a). Such sound macroeconomic management has been rewarded with a recent upgrade in Tunisia's international credit rating in December 2000 by Moody's and other credit rating agencies (Tunisia, 2001 e).

But as the East Asian Financial Crisis has shown, as strong as Tunisian macroeconomic fundamentals might be, they are not sufficient to avoid crises created by creditor panic or by sudden reversal of excessive capital inflows (Mathieson et al., 1998).

Financial System Soundness

Even with the promising results of the previously mentioned Word Bank banking sector restructuring program, one could argue that previous crises suggest that more must be done before enabling Tunisian banks to expand their activities on international capital markets. Given its relatively low experience in dealing on such markets, it is believed that risk-management practices must be increased (IMF 1999 b). Given that private

[14] Reports generated from annual bilateral discussions between the IMF and its member countries.

banks drastically outperform public ones[15], privatization of public banks is seen as a possible way of doing so. Although Tunisian authorities have recently sold their participation in the *La Banque du Sud* in 1998 and plan on privatizing l'*Union Internationale de Banques*[16] in the next fiscal year, this privatization process is purposely slow because they consider the banking system as crucial and do not want to replace a state monopoly in banking by a private one.

As for non-bank financial institutions that Tunisian authorities have attempted to develop, authors such as Knight (1998) believe that the lack of accurate and timely data dissemination is the most serious hurdle blocking their development. The lack of information and transparency has been argued by many to be an important factor of the over-investment and subsequent collapse in East Asia and has ignited demands for emerging markets to improve this capacity (Camdessus, 1996, 1998). In an attempt to improve the quality of the information on its economy, Tunisia has recently subscribed to the IMF Special Data Dissemination Standard (SDDS)[17] and adopted a new law on statistics to enable publication of more accurate information on macroeconomic variables (IMF, 1999 a). But as Griffith-Jones (1998) and Stiglitz (1998) point out, the increasing proportion of private-to-private capital flows make the development of accurate macroeconomic data on public finance virtually irrelevant. In this perspective, a consensus is developing amongst various analysts that even if countries like Tunisia improve data disclosure, they will still not be immune from future crises.

Curbing Short-Term Capital Inflows

In the light of its limited capacity to manage and supervise risk and of the insufficiency of data dissemination as a way to prevent crisis, one could argue that Tunisia should keep relying on controls to limit foreign borrowing. This "third line of defense" can be argued as being a necessary transitionary step in Tunisia's shift towards a greater integration into

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[15] The proportion of non-performing loans to total assets for public banks was almost twice the one of private banks (respectively 33% and 19%) (IMF, 2001 a).
[16] Bank that represents close to 8% of total banking sector assets (Sfar, 2001).
[17] The special data dissemination standard, created in 1996, is a system where voluntary countries publish key economic data on a timely basis (IMF, 1999 a).

world capital markets. As Chile and Columbia have done, Tunisia could gradually replace quantitative restrictions with policies having an impact on the composition, but not necessarily on the level, of foreign investment by modifying it "towards the longer end of the maturity spectrum" (Eichengreen, 1999). Although recent studies from the IMF claim that it is premature to describe the taxing of capital inflows from these countries as successful (Nadal-De Simone and Sorsa, 1999), one could argue that, in the aftermath of various financial crises caused by excessively quick capital account liberalization, it is time for a shift in the burden of proof and for countries to adopt these types of policies to curb short-term capital inflows.

Broader Policy Conclusions

Liberalization of financial systems being such a complex issue, one must not believe that the case study of Tunisia's experience can serve as a model for other countries to follow. Although the process analyzed has been argued to have increased the efficiency of Tunisia domestic financial system without exposing its economy to excessive volatility, one must be mindful of the caveat of this case study (as with case studies in general) in that it only holds true under the specific circumstances detailed throughout this paper. But this analysis of Tunisia's gradual financial liberalization and its comparison to Thailand's more rapid process joins other similar case studies advocating comparable general recommendations. Such is the case, for instance, with the investigation of Chile's various attempts to integrate international financial markets. After having followed a more rapid financial system liberalization in the 1970s that resulted in a banking crisis, Chile's more gradualist approach initiated in 1985 seems to have been much more successful (Johnson et al., 1997).

These studies advocate that developing countries with underdeveloped financial systems should avoid senseless and excessively rapid financial deregulation. As Stiglitz (1998) rightfully argues, although financial liberalization does offer potential benefits, it should not be seen as an end in itself. Liberalization should rather be seen as a means to achieve stable and efficient financial systems capable of leading to increase economic growth.

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