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A Comparative Analysis of Financial Sector Reforms and Policies in Countries Exiting Fragility

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Abstract

Financial sector reforms are part of the strategies that countries follow to exit from fragility, but the content and focus of these reforms and the priority they are given relative to other policies vary from country to country. Based on an archival search of publicly available World Bank and the International Monetary Fund country documents, this paper investigates and compares the experiences of seven countries (Armenia, Benin, Cambodia, the Dominican Republic, Rwanda, Senegal, and Viet Nam) that successfully and sustainably exited fragility during the 1980s and 1990s, focusing on the financial sector reforms that were implemented around the time of the exit. The review suggests a few broad patterns. Regardless of the original causes of fragility, successful exit strategies always included financial sector reforms, which invariably focused on short-term goals: stopping bank losses, establishing monetary control, and re-starting the engine of financial intermediation and the flow of credit to the economy. Longer-term financial development goals, such as financial deepening, were recognized as important, but the requisite policy interventions came later, after the financial sector had been restored to health and was able to discharge its basic functions. Crucially, substantial, hands-on, long-term technical assistance and capacity building were in all cases necessary to ensure the long-term success of these reforms.

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Introduction

Financial development, especially if starting from low levels, promotes capital accumulation, a more efficient allocation of investment, productivity growth, and ultimately economic development. It has also been shown to reduce income inequality and is strongly associated with poverty alleviation.[1] Therefore, financial development can, at least in theory, help countries affected by state fragility deal with both the symptoms and the causes of their fragility.

At the same time, state fragility can obstruct the process of financial development. Financial markets and, more broadly, financial activity rely critically on well-functioning institutions that protect property rights and provide a minimum of certainty; on an environment of trust among economic agents; and on the ability of policy makers to provide stable macroeconomic conditions. Fragile states, where these elements are in short supply, can be expected to have less developed financial institutions and markets—although the evidence on this is mixed.[2]

The close relationship between fragility and financial development means that financial reforms and policies are almost always part of the strategies that states follow in order to exit from fragility. However, the content and focus of these financial sector reforms and policies, their sequencing, and the priority they are given relative to other policy interventions vary widely from country to country. Are there lessons to be learned from the variety of country experiences? Is there an optimal formula or best practice for financial reforms that countries trying to exit fragility should follow? To the best of our knowledge, the extant literature is largely silent on these issues.

This paper attempts to shed some light on these questions by investigating and comparing the experience of a sample of countries that successfully exited fragility. The target audience is policy makers in fragile states, including those who support them with advice, financial assistance, or policy conditionality—notably donors, international financial institutions (IFIs), and other development partners. The paper analyzes the financial sector reforms these countries implemented as part of their exit strategy and examines whether there are lessons to be drawn for countries in similar circumstances. Since financial sector reforms are usually part of World Bank and IMF policy programs, the paper relies on material collected by an archival search of World Bank and IMF documents for these countries.

The remainder of the paper is organized as follows. The next section provides a primer on the conceptual and measurement issues related to fragility and the state of knowledge regarding exit strategies. The following section discusses the sample of countries and the sources of the material

[1] Beck, T., A. Demirgüç-Kunt, and R. Levine (2007), "Finance, Inequality and the Poor," *Journal of Economic Growth*, 12(1): 27-49; Levine, R. (2005), "Finance and Growth: Theory and Evidence," in: Aghion, P. and S. Durlauf (eds.), *Handbook of Economic Growth*, Amsterdam: Elsevier.
[2] See Barajas, A., R. Chami, and C. Fullenkamp (2021), "The State of Finance in Fragile States, in: Chami, R., R. Espinosa, and P. Montiel (eds.), *Macroeconomic Policy in Fragile States*, Oxford University Press.

for the analysis. The last section analyzes the financial sector reforms that were part of their exit strategy, and the paper concludes with some broad lessons.

State fragility: A primer

Concept and measurement

State fragility is a situation in which a country's state apparatus is of limited effectiveness in delivering a range of basic public services. These include establishing and maintaining legitimate and accountable political institutions; controlling the country's territory, protecting the population from violent conflict, and maintaining public order; meeting the basic human needs of the population; and fostering an environment conducive to sustainable economic growth.[3] If a "failed state" is one that fails to provide these basic services, a fragile state is one that faces a high probability of becoming a failed one. State fragility is often a precursor of state failure.

War and civil conflict frequently lead to state fragility and failure. Although state fragility may be caused during peacetime by other factors, notably major political or economic crises, war and civil conflict can have a devastating impact on life, civic institutions, and physical assets; cause mass displacement; increase inequality; depress economic opportunity, especially for more vulnerable groups; and fuel grievances and perceptions of injustice that erode trust in institutions. These effects can sometimes take decades to overcome. In recent years, the incidence of violent conflict has risen, making it an increasingly relevant factor behind observed state fragility worldwide.[4]

Fragility is a multi-faceted concept that is difficult to measure. Although the definition of "limited effectiveness in providing public services" is widely used, it is not precise: some states may be unable or unwilling to provide an adequate level of certain basic services while being quite effective in other dimensions. Measuring fragility thus requires combining as many of these dimensions as possible into an aggregate indicator. Of the several such indicators that have been proposed, the two most common are:[5]

- The World Bank's Country Policy and Institutional Assessment (CPIA) index, which rates countries against a set of 16 criteria grouped in four clusters: (i) economic management; (ii) structural policies; (iii) policies for social inclusion and equity; and (iv) public sector management and institutions. The CPIA focuses on the economic dimensions of state

[3] OECD (2009), *Preventing Violence, War, and State Collapse: the Future of Conflict Early Warning and Response*, Paris: Organization for Economic Co-operation and Development.
[4] United Nations and World Bank (2018), *Pathways for Peace: Inclusive Approaches to Preventing Violent Conflict*, The World Bank.
[5] For an overview of the different metrics, see Chami, R. et al. (2021), "Macroeconomic Policy Issues in Fragile States: A Framework," in: Chami, R., R. Espinosa, and P. Montiel (eds.), *Macroeconomic Policy in Fragile States*, Oxford University Press.

effectiveness, and the criteria attempt to capture the key factors that foster growth and poverty reduction. For each criterion, countries are rated from 1 (low) to 6 (high), and an unweighted average score of 3.2 or less is generally seen as the threshold of state fragility. The CPIA is also used by the IMF and other IFIs.

- The Fund for Peace's Fragile States Index (FSI), which has broader coverage, consisting of five groups of indicators measuring state cohesion, economic conditions, political legitimacy and public service provision, social conditions, and external intervention.

Regardless of the indicator used, state fragility appears to be widespread and persistent. The various aggregate indicators tend to agree on which countries are at the bottom and the top of the list, but there is less agreement in the middle of the rankings. Nevertheless, fragile states are home to nearly 1 billion people. They exist in most parts of the globe, including Africa, the Middle East, and parts of Asia and Oceania. Although fragile states exist in both low- and middle-income countries, they are more prevalent among the former: about half of the world population living in extreme poverty resides in fragile states.[6] Fragility is also hard to shake off: once a state becomes fragile, it may take several years to exit fragility, which has led many to talk about a "fragility trap."

Fragility, economic performance, and financial development

State fragility is unambiguously associated with a lower level of economic performance. In fragile states, the formal sector tends to be small relative to the size of the economy and dominated by small and inefficient firms. In many cases, crime and theft are prevalent and private firms have to cover security costs, as well as deal with power outages or water insufficiency. Fiscal capacity is weak and governments have difficulty collecting taxes to finance essential public services, often relying on volatile commodity revenue. At the same time, military and security needs or political pressures from competing groups mean that public expenditure pressures are high, leading to unsustainable fiscal positions. Corruption and rent-seeking also tend to be widespread. Fragile states tend to have weaker and more vulnerable external positions, in many cases relying on commodity exports, remittances, and official development assistance (ODA) as the major sources of foreign exchange. They are also prone to more frequent inflation episodes and higher growth volatility than non-fragile states.[7] As a result, fragile states are poorer in per capita terms than non-fragile states in the same income group.

The "fragility trap" hypothesis suggests that state fragility and economic underperformance may be tied in a vicious circle. Weak capacity and the inability to provide basic public services

[6] See IMF (2002), *IMF Strategy for Fragile and Conflict-Affected States*, IMF Policy paper, March 2022, International Monetary Fund; and Chami, R. et al. (2021), *op. cit.*

[7] For a review of the evidence, see Assaf, N., M. Engman, A. Ragoussis, and S. Agrawal (2021), "The Private Sector in Fragile Situations," in: Chami, R., R. Espinosa, and P. Montiel (eds.), *Macroeconomic Policy in Fragile States*, Oxford University Press.

mean that the state loses legitimacy, which erodes tax compliance, undermines confidence, depresses investment, and encourages rent-seeking. This in turn weakens the state further, increasing economic vulnerabilities and the costs for the private sector. Countries that find themselves in this situation may find it harder to escape fragility.

The correlation between state fragility and financial development is less clear-cut, though recent evidence points to a robust negative association.

- Measured against the rest of the world, fragile states as a group have lower levels of banking penetration, stock market depth, and financial inclusion. They also rank lower in terms of aggregate indicators of financial development, such as, for example, an indicator that combines nine indices to measure depth, access, and efficiency of financial institutions and financial markets.[8] However, there is considerable diversity within the fragile states group, often reflecting the degree of financial development attained before the onset of fragility.

- When benchmarked against countries with similar structural characteristics unrelated to fragility (such as income level, population size and density, old age dependency ratio, and other factors),[9] some fragile states overperform their structural benchmarks in at least some dimensions.

- A more granular econometric analysis examining seven different financial development indicators—three on inclusion, two on banking depth, and two on stock market depth—also shows a mixed picture: although at least half of the fragile states underperform their structural benchmarks, there are still many that overperform. This analysis, however, reveals a more nuanced pattern: fragile states, particularly in the group of lower-income countries, are more likely to underperform their structural benchmarks in the area of financial inclusion than in any other area.[10]

- When accounting for both observed and unobserved heterogeneity, the relationship between financial development and state fragility is unambiguously robust and with a

[8] Svirydzenka, K. (2016), "Introducing a New Broad-Based Index of Financial Development," IMF Working Paper 16/05, International Monetary Fund.
[9] Čihák, M., A. Demirgüç-Kunt, E. Feyen, and R. Levine (2012), "Benchmarking Financial Systems Around the World," Policy Research Working Paper 6175, The World Bank. One weakness of this analysis is that some of these structural factors—notably income—are correlated with both state fragility and financial development. There is no easy way out of this endogeneity, so the findings of the benchmarking exercise should be taken with a degree of caution.
[10] Barajas, A., R. Chami, and C. Fullenkamp (2021), *op. cit.*

negative sign, with the result mainly driven by a country's financial institutions' depth and access.[11] Causality remains, however, an open and intractable empirical issue.

This brief overview of the evidence suggests that state fragility is associated with a lower level of financial development, especially in the area of financial inclusion. However, it is important to recognize the heterogeneity within the fragile states group. It appears that the circumstances leading to state fragility may not affect financial markets or institutions uniformly.

Strategies for exiting fragility

Exiting from fragility is a complex process of holistic change. Ending violence, ensuring physical security, and restoring the legitimacy of state authority are necessary but not sufficient: ending fragility requires far-reaching political, economic, and financial reforms. The multi-faceted nature of fragility, however, means that there is no single blueprint or strategy for these reforms: to be successful, each country's exit strategy must be distinctive and highly context-specific.

Moreover, the success of these reforms is contingent on their timing or other conditions that may not be entirely under the control of policy makers. Fragility tends to be a locally stable equilibrium (this is the essential meaning of the "fragility trap") as the result of several interdependent characteristics that lock a society into a dysfunctional but stable situation. Successfully transitioning from a "weak" to a "strong" state equilibrium requires not just following a policy strategy tailored to the circumstances of the individual country, but also meeting a number of other conditions (the "scaffolding" needed to build out of fragility).[12] These conditions include the society being in a "pivotal moment," in which the government is willing to face the reality that past policies have failed and a new approach is needed; the constructive engagement of the international community; and the majority of the population being willing to embrace a new narrative, usually—but not always—the result of new leadership. In addition, *sustainably* exiting fragility, i.e., transitioning to a "strong" state equilibrium and staying there, is not just a matter of building a powerful state. Powerful states may become despotic and predatory, eventually undermining their legitimacy and risking a return to fragility. Instead, it requires empowering and mobilizing society alongside the state, and keeping both of them developing in a balanced way inside what has been called the "narrow corridor."[13]

[11] Custodio, I., P. Calice, A. Lucas, and J. Schaumburg, "Financial Development and Fragility: A Clustering Analysis," *forthcoming*.
[12] Collier, P. (2021), "Transition Programs: A Theory of the Scaffolding Needed to Build out of Fragility," in: Chami, R., R. Espinosa, and P. Montiel (eds.), *Macroeconomic Policy in Fragile States*, Oxford University Press.
[13] Acemoglu, D. and J.A. Robinson (2019), *The Narrow Corridor: States, Societies, and the Fate of Liberty*, Penguin Press.

Building on their experience,[14] **the World Bank and the IMF have established strategies for engaging with fragile states**[15] (labeled "states affected by fragility, conflict, and violence"—FCV—by the World Bank and "fragile and conflict-affected states"—FCS—by the IMF). Given the remit of the institutions, these strategies focus on the economic and financial policy components of the broader exit strategies, while acknowledging the critical importance of the security, political, and other components. Both emphasize the importance of adopting a flexible and differentiated approach; enhancing partnerships with other humanitarian, development, and security actors; ensuring that the policy content and any advisory or capacity-building activities are tailored to country circumstances and absorptive capacity; and strengthening internal procedures in the two institutions, including personnel training and management. However, these high-level strategies do not enter into details regarding the *content* of economic and financial policies, nor do they identify priority reforms for exiting fragility: they provide a useful framework for the staff of the two IFIs in engaging with fragile states but little direct guidance to policy makers in these countries.

Methodology, country sample, and sources

The purpose of the paper is to shed some light on the financial sector strategies needed for exiting fragility. The paper attempts to identify the policies and reforms that are commonly associated with building resilience and sustainably exiting fragility. The net is cast deliberately wide, to include reforms and policies aimed at restoring or ensuring financial stability; strengthening financial sector regulation, supervision, and infrastructures; broadening access to finance; and developing local capital markets. Fragile states typically face challenges in several of these areas, and exiting fragility involves—among many other reforms—overcoming these challenges.

Given the absence of a general model or blueprint for exiting fragility and the wide diversity of individual county experiences, the paper adopts a granular, empirical approach. It examines the experience of countries that successfully and sustainably exited fragility, focusing on the financial sector reforms that were implemented around the time of the exit. The goal is to build a narrative, rather than a theory, of the role these reforms played in the process of exit. Although this synthetic narrative would not necessarily apply to *all* countries in *all* situations trying to exit from fragility, it may hold relevant lessons for many.

The paper examines the experience of seven countries that successfully exited fragility (dates in parentheses are the dates of exit from fragility): *Armenia* (1994), *Benin* (1991), *Cambodia*

[14] IMF Independent Evaluation Office (2018), *The IMF and Fragile States: 2018 Evaluation Report*, International Monetary Fund; World Bank Independent Evaluations Group (2021), *World Bank Engagement in Situations of Conflict: An Evaluation of FY10-20 Experience*, World Bank.
[15] World Bank (2020), *World Bank Group Strategy for Fragility, Conflict, and Violence 2020-25*, World Bank; IMF (2002), *IMF Strategy for Fragile and Conflict-Affected States*, March 2022, International Monetary Fund.

(2000), *Dominican Republic* (1997), *Rwanda* (1998), *Senegal* (1995), and *Viet Nam* (1989). The classification of fragility and the date of exit are based broadly on the CPIA index. Appendix 1 summarizes the experience of each of these countries and the circumstances of their exit from fragility.

The selection of countries was based on four criteria:

- *Sustainable exit* from fragility, i.e., the countries continued to be classified as non-fragile for at least ten years after exit.
- Broad *geographical representation*.
- *Diversity* of fragility experience, i.e., the sample covers cases where fragility emerged from a combination of different circumstances, such as an economic crisis, breakdown of the political system, violent conflict, etc.
- *Complexity* of fragility experience, i.e., fragility did not emerge *solely* as the result of war, while beforehand the state was otherwise stable and effective.

The purpose of these criteria is to ensure that any lessons learned would have the broadest possible applicability. The rationale for the last criterion, in particular, is to exclude cases (e.g., Cyprus in the 1970s or Lebanon in the 1980s) with functioning states and financial systems that descended into fragility only because of war, displacement, or the arrival of UN peacekeepers. In cases like this, financial reforms and policies would play little or no role in the exit from fragility, and there would be no lessons to be drawn for financial sector policy makers elsewhere.

Data and information for the financial sector policies and reforms around the time of exit from fragility are sourced from World Bank and IMF documents for these countries. Financial sector reforms are often undertaken with support of the World Bank and the IMF. Even when they do not form a major part of their respective adjustment programs, these country documents provide fairly detailed information about these reforms and policies. The main source documents for each country are listed at the end of the paper.

This approach is subject to three caveats.

- Although the sample of countries is as diverse as possible, it is still small. There are not many countries that (i) experienced fragility relatively recently (so that it is captured by the CPIA index, which is used for measurement and consistency) and (ii) meet the conditions for inclusion in the sample—especially the requirement to have remained stable for at least ten years after exit from fragility. The reader should be cautious about generalizing from the review of the experience of seven countries to all other cases of fragility.

- The World Bank and the IMF did not focus in depth on financial sectors in the 1980s and 1990s. Their policy advice and conditionality was concentrated on fiscal, monetary, and exchange rate policies—and, for the World Bank, poverty alleviation and other structural areas. It was only after the Asian financial crisis of the late 1990s that both institutions started focusing more systematically on financial sector issues, notably through the Financial Sector Assessment Program (FSAP), and only in the last decade or so that the IMF expanded its mandate to cover explicitly macrofinancial issues. Still, the two institutions' documents contain the most comprehensive record of financial sector reforms available for these countries.

- Not all country documents of the two institutions are in the public domain. This is particularly a constraint for IMF documents, as the Fund had a much more restrictive dissemination policy than the World Bank, especially in the 1980s and early 1990s. In one case (Benin) where IMF reports are not available, the paper relies on World Bank documents.

Main findings

Finding No. 1. Financial sector reforms were part of the strategy of exit from fragility in all cases, but not always among the top priorities: their timing relative to other reforms varied significantly from country to country.

Based on the evidence from the sample of country cases, successful exit strategies always included some financial sector interventions. Whether they involved liquidating, restructuring, or recapitalizing failing banks (and dealing with the fiscal implications or recapitalization), cleaning up balance sheets, establishing a proper legal and regulatory framework, strengthening financial sector oversight, or a combination of these elements, some financial sector reforms were part of the policy strategy associated with exit from fragility in all seven countries.

However, the financial sector was not always a separate focal point of early IFI operations. In some cases (*Armenia, Dominican Republic*), a financial sector reform agenda was a distinct component of the World Bank and IMF programs around the time of exit from fragility. In other cases (*Cambodia, Rwanda*), these early IFI operations did not include a separate financial sector component: instead, individual financial sector interventions appeared as elements of other parts of the strategy (see also *Finding No. 2*). In those cases, these early operations focused primarily on other economic policy priorities, such as addressing acute macroeconomic instability, establishing control over the public finances, or financing humanitarian needs. Financial sector reforms appeared as a separate agenda in later World Bank and IMF country strategies and programs—a year or more after exit from fragility.

This may reflect a different order of priorities across countries. It may, of course, be simply a matter of presentation. But it seems plausible to deduce that in cases where there was no separate financial sector reform agenda and individual financial sector measures appeared under other headings, the financial sector *per se* was not seen as one of the most urgent priorities.

If true, these disparities in prioritization probably reflect the urgency of tackling other aspects of fragility, as well as capacity constraints. Although it is difficult to second-guess decisions taken years ago at a time of uncertainty and crisis, it appears that policy makers (and the two IFIs) may have decided that other challenges were more pressing. In the case of *Rwanda*, for example, these included the return and re-settlement of millions of refugees and internally displaced persons, while in *Cambodia*, they involved de-mobilization and stopping illegal logging. There is, of course, no trade-off between these priorities and financial sector reforms: in principle, they could be pursued simultaneously. But in conditions of crisis, local implementation capacity (as well as the IFIs' own delivery capacity) is limited, forcing policy makers to prioritize. Local implementation capacity constraints at all levels—legislative, administrative, material, and cognitive—are frequently mentioned in source documents for the countries in the sample (see also *Finding No. 8*). In any event, financial sector reforms were brought into sharper focus at a later stage in both countries.

Finding No. 2. In many cases, financial sector reforms were seen as instruments to achieve other policy goals rather than as major independent elements of the strategy.

Financial sector reforms did not always appear in the World Bank- and IMF-supported programs as a goal in themselves but often as a means to achieve other policy objectives.

- In the case of *Senegal*, for example, two of the highest priorities for the IMF were (i) to manage the cost of recapitalizing the insolvent banks and ensuring a rescheduling of their debts to the (regional) central bank so as not to jeopardize the task of getting public finances under control; and (ii) to strengthen the monetary transmission mechanism to bring inflation under control. Banking sector interventions were seen primarily through those lenses.

- In the cases of *Rwanda* and *Viet Nam*, the World Bank saw financial sector reforms as necessary steps to re-start growth, strengthen the conduct of monetary policy and—in the case of *Viet Nam*—as a crucial component of public enterprise reform. In early country strategies and program documents for these countries, financial sector reforms appeared as part of these agendas.

This "instrumental" approach to financial sector reforms may reflect institutional mandates. Neither the World Bank nor—especially—the IMF focused deeply on financial sector issues in the 1980s and 1990s. It should therefore not be surprising that both institutions approached financial sector issues from the perspective of what each saw as their primary mandate at that time. It may also be that in specific country cases, the two IFIs, in agreement with domestic policy makers, had decided that financial sector reforms—important as they might be over the medium term—should be assigned a lower priority relative to other policy goals (see *Finding No. 1* above). Nevertheless, both institutions recognized the importance of a well-functioning financial sector for the success of their overall strategy and the country's exit from fragility.

This leaves open the question whether the approach to financial sector reform would have been different if the two IFIs had seen it as a central part of their mandate and an important end in itself. Would the financial sector policy agenda in these countries have been broader, have a more medium-term focus (see *Finding No. 4* below), or be sequenced in a different way (see *Finding No. 5*) if the IMF saw its remit as ensuring macrofinancial, rather than simply macroeconomic stability? Or if the two institutions had available the financial sector expertise they built internally since the early 2000s? Or if they could use a diagnostic tool like the FSAP, which only started being deployed (on a voluntary basis for the countries) in 1990? In at least some of the cases, the answer to these questions is most likely yes. After all, the mainstreaming of financial sector issues in both institutions since the turn of the century was in response to gaps in their approach revealed during the Asian financial crisis in the late 1990s and the global financial crisis in 2008. However, speculating exactly *how* the financial sector agenda would have been different in each of the countries if the two IFIs had known then what they know today lies outside the scope of this paper.

Finding No. 3. The main goal of financial sector reforms in fragile states—aside from their instrumental value in achieving other policy objectives—was to re-start or accelerate the process of financial intermediation.

Based on the evidence from the seven country cases, improving the process of financial intermediation was seen by both IFIs as the main contribution financial sector reforms could make to the overall strategy of exit from fragility. The goal was the same regardless of whether the immediate challenges to be tackled were weak balance sheets, under-provisioning, undercapitalized or bankrupt banks, excessive regulation, the continued financing of loss-making state enterprises, or the lack of a market-based banking system.

There was no attempt to break down—and differentiate between—the different elements of "financial intermediation." The term was apparently seen by the staff of both IFIs as self-explanatory, and there was rarely, if at all, any discussion of its various aspects, like savings mobilization, credit provision, risk intermediation, maturity transformation, or the provision of payments services. There was no attempt to diagnose whether the obstacles to "financial intermediation" were related to some of these aspects more than to others, and to target the reforms to these individual aspects. Specific measures to improve the speed of payments and settlements, in particular, were prioritized from the start in World Bank operations in only in two countries (*Cambodia* and *Viet Nam*).

One likely explanation is that in all seven countries, financial sectors were bank-dominated. In bank-dominated systems, these aspects of financial intermediation are usually "bundled" and performed by banks (with the exception of payments and settlements, which require additional infrastructure). It may therefore be understandable that the staff of the two IFIs considered it unnecessary to "unpack" and delve deeper into the separate elements of financial intermediation. And once again, capacity constraints (on both IFIs and local counterparts) in conditions of economic crisis may have also played a role.

There were few references to financial development or deepening as a separate objective of financial sector reforms. Extending the reach of financial services was mentioned in some World Bank country documents as an important economic and social goal, but always over the longer term (see *Finding No. 4* below). In all cases, the reforms included in the early operations around the time of exit from fragility were focused on dealing with urgent obstacles to the efficiency of financial intermediation. Financial deepening and specific measures to promote it, including financial education, etc., started appearing (mainly in World Bank) operations some years after exit from state fragility.

Finding No. 4. In line with the rest of the economic reforms that formed part of the strategy of exit from fragility, financial sector interventions typically had a short-term horizon.

Early operations by both IFIs around the time of exit from fragility were predominantly short-term focused. The source documents are clear—and often discuss at some length—that financial sector reforms must continue over a longer time horizon and should form part of future IFI programs. However, the emphasis in the early operations was always short-term measures that would yield "quick wins" in terms of the key objective: re-starting or improving the process of financial intermediation. For example:

- In the case of *Armenia*, the World Bank's Country Economic Memorandum 1993 described as the immediate priority to "develop a legal, regulatory, and institutional framework capable of supporting a commercial banking system with separation of banks and their client enterprises, clear incentives and financial discipline, a strong role for the central bank, […] and a strategy to address ownership and oversight of banks." In contrast, "it would take several years to […] build a banking sector with incentives to encourage financial savings, expanding financial services, and reducing public ownership of financial institutions."

- In the case of the *Dominican Republic*, the IMF distinguished between "immediate reforms to strengthen the banking system and eliminate distortions in the credit markets" on one hand, and "further financial deepening" on the other hand, which would be "key to promoting domestic saving and channeling it toward the most productive uses." The latter would require strengthening the institutional setting, promoting competition, enhancing transparency in financial markets, and reforming the social security system—all of which would be longer-term reforms.

- In the case of *Cambodia*, the World Bank's Structural Adjustment Credit around the time of exit from fragility emphasized measures to "make banks an effective channel of intermediation of savings and investment and […] promote de-dollarization." These included submitting all existing banks to a process of re-licensing, closing unviable ones and restructuring the rest, and conducting on-site inspections through international audit firms. At the same time, the document noted that the "longer-term development agenda" aimed at "encouraging the private sector as an engine of growth" would involve further financial sector interventions (such as legal reforms, privatization, strengthening the supervisory capacity, and building a domestic government debt market).

This short-term focus was consistent with the time horizon of all other economic reforms underpinning the exit from fragility. It was to be expected that in a situation of crisis, policy-makers and the two IFIs would concentrate on short-term interventions addressing the most immediate concerns. This was also the case in all other economic policy areas, notably fiscal and monetary policy.

Finding No. 5. In terms of sequencing, early financial sector reforms in fragile states prioritized (i) establishing the foundations of a market-based financial system, if these were lacking; (ii) restoring the commercial viability of banks; and (iii) establishing the authority of the regulatory agency and strengthening the legal framework for supervision.

Within the short-term financial sector reforms that were the focus of early IFI interventions in fragile states, there was an implicit sequencing order. It is of course risky to generalize from a small number of disparate country cases, each facing very different fragility challenges, so this finding must be taken with caution. Still, a close reading of the source documents for the seven country cases suggests a rough priority ranking.

- In cases where fragility emerged—at least in part—as a result of a fundamental break with the previous political and economic order (*Armenia, Cambodia, Viet Nam*), the first priority was to establish the legal and institutional foundations of a market-based financial system. This involved passing basic commercial and banking laws; severing the link between banks and specific sectors, activities (e.g., foreign trade), or enterprises; opening up the banking system to new entrants to introduce an element of competition; and separating the functions of the central bank from those of commercial banks. It was understood that these foundational reforms would not, by themselves, be sufficient to kick-start the process of market-based financial intermediation. Indeed, it was clear that some of these would aggravate the financial position of existing banks in the short term and create additional challenges: in the case of *Viet Nam*, for example, the World Bank noted that "once the façade of central planning is removed, the banking sector is likely to be technically insolvent and highly dependent on central bank financing, which is inimical to monetary control objectives." Nevertheless, these steps were seen as necessary pre-conditions for the success of further reforms.

- In cases where the foundations of a market-based financial system were in place—or once they were established—the priority was to ensure the commercial viability of at least part of the banking system, so that some banks could carry out the basic functions of financial intermediation. Depending on the country, this involved stopping loss-making activities; closing or placing unviable banks under administration; restructuring debts; strengthening the capital positions of the remaining banks, including by introducing minimum capital requirements or recapitalizing with budgetary support, if necessary; and removing interest rate ceilings, credit controls, and punitive reserve requirements. In the case of *Benin*, for example, the World Bank and the IMF jointly agreed with the authorities at an early stage "a program of actions to restore the viability of the banking system" including liquidation of three banks, restructuring and recapitalization of others with government funds, reorganization of the rural credit network, and rescheduling of the banks' debts to the (regional) central bank.

- The third priority in all cases was to strengthen banking supervision. This involved strengthening the legal authority and operational independence of the central bank or supervisory agency, establishing or reorganizing the supervisory functions and departments within these institutions, aligning regulations with international standards, streamlining judicial procedures, and providing training to supervisory staff.

These three priorities were not necessarily implemented sequentially: the main difference was the time horizon over which they were expected to bear fruit. Depending on implementation capacity, early IFI programs might include simultaneous actions in more than one of these areas (as, for example, in the case of *Armenia*). The difference was the time horizon over which they would yield results: measures under the first two priorities were expected to produce results in a matter of months, while steps to improve supervision would have a cumulative impact over several years.

Finding No. 6. A common challenge in many cases was the effective separation of banks from client companies.

This challenge was to be expected in countries emerging from a central planning system (*Armenia, Cambodia, Viet Nam*). Moving toward a market-based system would require transforming the sector-specific, specialized banks into universal banks. This would, in turn, require restructuring the state-owned enterprises previously dependent on the specialized banks, as well as embedding a culture of commercial competition into the new, universal banks.

However, it turned out to be an issue in market-based systems as well. Excessive exposure concentrations to large client enterprises and connected lending were a common cause of non-performing loans and bank losses. This problem was exacerbated by accumulated government arrears to these enterprises, for example, in *Benin* and *Senegal*. For this reason, in the case of *Benin*, steps to reduce government intervention in the allocation of bank credit were accompanied by limits on large exposures in line with Basel requirements. And in the *Dominican Republic*, early measures included limits on lending in order to minimize concentration risk—as well as steps to enforce these limits.

Finding No. 7. The entry or expanded presence of foreign banks was actively encouraged in some cases as a means to jump-start financial intermediation.

Foreign banks were sometimes seen as a shortcut to the achievement of multiple early program objectives, such as ensuring a critical mass of viable banks, introducing competition, and raising skills and the standards of governance in the financial system.

- In the case of *Benin*, alongside liquidating or restructuring existing banks, early World Bank and IMF interventions included the "creation of a new bank with the majority share held by a foreign banking entity." It was originally expected that identifying a suitable and interested foreign partner and having the new bank in operation would take place in a matter of a few months. In the event, it took more than a year. Source documents do not provide an evaluation of how effective this step actually was in achieving the envisaged objectives.

- A slightly different approach was followed in *Rwanda*, where restoring the viability of five of the banks—in two of which the government or public entities had a majority stake—required injections of new capital. In this case, partly to minimize the fiscal cost and partly to encourage a larger footprint of foreign banks, the government decided to become a minority shareholder, inviting foreign shareholders to acquire the majority.

- Finally, in the case of *Viet Nam*, early interventions included removing the barriers to entry of foreign banks. Instead of outright foreign ownership, however, foreign banks were encouraged to enter into joint ventures with domestic banks. A World Bank Discussion Paper described this approach as "following a long-established Asian principle that you do not destroy old institutions, but rather you create new ones which quickly become dominant."

Finding No. 8. In most cases, the financial sector reforms associated with exit from fragility included significant technical assistance and capacity-building efforts.

Skills and capacity constraints in both the private and public sectors were major obstacles for the effective implementation of exit strategies in most of the countries in the sample. These included a combination of (i) shortages in human capital (education, skills, and experience) and (ii) cultural hurdles that needed to be overcome in order to build viable and efficient financial systems. The former was prevalent in lower-income countries with relatively low average levels of educational attainment, such as *Benin*. The latter was more relevant in countries emerging from decades of central planning, such as *Armenia* and *Viet Nam*. The challenge was obviously greater in cases like *Cambodia*, where both aspects were present.

To tackle this challenge, strategies for exit from fragility typically included a substantial and wide-ranging technical assistance and capacity-building component on financial sector issues. Depending on the needs, this sometimes took the form of embedding expatriate experts in the central bank and government agencies to provide hands-on support and direction.

- In *Armenia*, the IMF appointed three resident advisors to the central bank (one on banking supervision, one on accounting, and one on general issues); the World Bank provided assistance on privatization and restructuring, risk assessment, and workout procedures for impaired assets; both IFIs provided technical assistance in developing a legal framework compatible with a market economy; and USAID supported the development of a Treasury bill market and commercial bank and enterprise accounting.

- In *Benin*, expatriate technical advisors from the regional central bank and France were engaged to supervise the auditing of client accounts and reimbursement of depositors, manage loan recovery and bank liquidations, and train staff of banks and rural cooperatives. The two IFIs provided technical assistance in several other areas, including modernizing the legal framework and streamlining judicial procedures for obtaining guarantees and collateral and issuing land title arrangements and records.

- In *Cambodia*, once the process of re-licensing all banks was completed, the IMF and World Bank helped identify experts to manage the liquidation of non-viable banks and the restructuring of those that were deemed potentially viable; assisted in preparing draft laws on commercial contracts, arbitration, corporate insolvency, secured transactions, and a new Financial Institutions Law; and provided technical assistance to the central bank in bank ratings and on-site inspections. In addition, together with the Asian Development Bank, they assisted the restructuring and recapitalization of the Foreign Trade Bank, identified an expatriate outside director with management expertise for its Board, and provided training to its staff on audit, portfolio valuation, and loan restructuring.

- In *Viet Nam*, the two IFIs provided technical assistance and on-site staff training in a broad range of topics, including statistical data collection and analysis, macroeconomics, econometrics, and banking supervision, supported by the assignment of long-term external experts to the central bank; as well as assistance in strengthening the payments system, including the introduction of new payments instruments.

It should be underscored that this list underestimates the true extent of capacity-building effort and resources expended in these countries during their exit from fragility. The source documents focus on economic policies and conditionality, and provide only a high-level summary of the two IFIs' technical assistance activities. In addition, they do not cover the extensive training activities of the IMF Institute for officials from member countries. Last but not least, with very few exceptions, the source documents do not identify capacity-building activities by bilateral donors.

Lessons learned

Before generalizing from the findings of the analysis of the country cases, it is worth recalling the caveats. Although the sample of cases was deliberately selected to be as broad and as representative of different experiences of fragility as possible, it is still small. The analysis is based on publicly available documents of the World Bank and the IMF. Although these documents contain the most comprehensive summary of financial sector reforms during the process of exit of these countries from fragility during the 1980s and 1990s, they were produced at a time when the two institutions—especially the IMF—did not see financial sector issues as a core part of their mandate. This is likely to result in less detailed coverage of these issues than could perhaps be warranted.

With these caveats in mind, the findings suggest certain lessons for policy makers in countries trying to exit fragility, as well as their international partners.

- ***Do not forget the financial sector***. Regardless of its original causes, exiting state fragility requires a strategy of far-reaching economic reforms across a broad front. The financial sector plays a central role in a well-functioning economy, and financial sector interventions should be part of this strategy. If there are pressing humanitarian, security, or other needs, these should, of course, be given priority. But it is unlikely that a successful exit can be achieved and sustained without some early action in the financial sector.

- ***Ensure that the fundamentals are in place before launching other reforms***. Taking steps to create an efficient financial sector that can mobilize savings to finance growth is futile if the fundamental legal and institutional framework for market-based banking and finance is lacking. This may require reforms that are not specific to finance, such as establishing a modern legal framework for contracts, commercial activity, audit, collateral, corporate governance, and bankruptcy; re-vamping judicial procedures; or establishing new mandates for existing institutions. In addition, it would almost certainly require steps to ensure an arm's length relationship between commercial banks and their client enterprises, stop connected lending, and limit large exposures.

- ***Focus on short-term goals: stopping bank losses and re-starting the flow of credit to the economy***. In the acute economic and financial crisis that often accompanies state fragility—whether it is its cause or effect—banks are likely to be accumulating losses (at least part of which will likely be hidden in the balance sheet). Before addressing the ills of the financial sector, one must first stop the bleeding. This requires some combination of performing audits and asset quality reviews; closing down non-viable banks or placing them under administration; wiping out the claims of existing shareholders (including possibly the government); restructuring bank debts; consolidating bad assets; establishing recovery procedures; deciding how much compensation of depositors is appropriate and feasible; ending financial repression and excessive government interference in the credit allocation process; introducing some measure of liberalization of interest rates; and ensuring that at least some viable banks remain in the system, including through fresh injections of capital, if necessary. These measures should take priority over all other financial sector interventions: without them, losses—and eventually budgetary costs—will continue accumulating, the process of financial intermediation will remain hindered, and the monetary transmission mechanism will be impaired, jeopardizing the broader economic stabilization efforts.

- ***Start putting in place the foundations of sound financial oversight***. To stay with the medical metaphor, in addition to stopping the bleeding, one must also ensure that it does not start again. This is the purpose of strengthening financial sector oversight. First and foremost, this requires ensuring the legal authority of the central bank or supervisory agency, as well as giving it the tools it needs to collect and analyze data, issue regulations, conduct inspections, take early corrective action, and play a leading role in the resolution of non-viable financial institutions. Once these elements are in place, the supervisory functions should be continuously upgraded in line with internationally recognized principles and best practice. It is important to keep in mind, however, that in contrast to other short-term interventions, progress in this area is likely to be slower and more gradual.

- ***Longer-term goals can wait***. Longer-term financial development goals, like financial deepening, can wait until the financial sector has been restored to health and able to discharge the basic functions of financial intermediation. Pursuing the goal of financial deepening requires time and resources that are likely to be limited. From the point of view of exiting state fragility as quickly as possible, experience suggests that it may be more efficient to spend these resources on stabilizing the financial sector and re-starting the process of financial intermediation, and leave the pursuit of financial deepening for a later stage.

- ***Be prepared to support these measures with substantial, hands-on, long-term technical assistance and capacity building***. In contrast to many other economic activities, finance is both skills-intensive and heavily regulated. Restoring the efficient functioning of the financial sector thus requires a wide range of technical skills and expertise both in the regulatory agency and in individual financial institutions. These skills are likely to be in short supply in countries trying to exit fragility. Extensive technical assistance is therefore necessary to support the implementation of financial sector reforms. Indeed, in the early stages, the appointment of expatriate experts to manage some of these reforms directly may be needed. Given that such technical assistance is likely to be offered by different donors, effective coordination of their efforts is crucial for its success.

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Appendix 1. The experiences of fragility and exit in the sample countries

Armenia

Armenia experienced major economic disruption and political turmoil in the period before and during the dissolution of the USSR, including tensions with neighboring Azerbaijan over Nagorno-Karabakh, a long-disputed territory administered by Soviet Azerbaijan with a majority Armenian population. On December 7, 1988, an earthquake devastated a large area of the country, causing 20,000-30,000 deaths; extensive damage to industry and infrastructure; and leaving about 500,000 Armenians homeless of a total population of about 3.7 million. Armenia's declaration of independence in September 1991 exacerbated the tensions with Azerbaijan, which turned into a full-scale war in early 1992. The combined impact of the 1988 earthquake; the war; Azerbaijan's blockade of Armenia's border in the east (which Türkiye in the west joined in support of Azerbaijan in 1993); the influx of an estimated 300,000-500,000 ethnic Armenian refugees from Nagorno-Karabakh; and the economic legacy of central planning meant that the new Armenian state emerged in conditions of high fragility and economic collapse: GDP is estimated to have declined by some 60 percent during 1991-93. Nevertheless, the government launched a program of political reform and transition to a market economy, including the introduction of a national currency at end-1993 to replace the ruble, with strong support by the international community and the Armenian diaspora. After a Russian-brokered ceasefire ended the fighting in 1994, reforms accelerated. The economy started growing and investment began to revive from negligible levels, inflation fell rapidly and, after peaking in 1994 at over 35 percent of GDP, the current account deficit started declining. Armenia is considered to have exited state fragility in 1994.

Benin

Benin is a small country with an economy dominated by agriculture. Cotton is the main export and the bulk of foreign exchange receipts. After a military coup in 1972, the country became officially a revolutionary socialist state (the People's Republic of Benin), most private businesses and financial institutions were nationalized, collective farming was established, many public enterprises were created to control key economic sectors, taxes were raised substantially, the civil service tripled in size, and extensive public industrial investment was financed mainly by foreign borrowing. The initial impact of these policies, combined with the oil and uranium boom in neighboring Nigeria and Niger (which fueled re-export trade through Benin's deep-sea port of Cotonou, one of the largest in West Africa), boosted growth in the late 1970s and early 1980s. But by the mid-1980s, the boom in neighboring countries had ended, state revenues in Benin fell substantially, domestic macroeconomic imbalances were becoming unsustainable, and the CPIA index for Benin slipped into fragility territory. In early 1989, a domestic banking crisis led to a deposit freeze and a further sharp drop in tax collection, resulting in payment arrears to civil servants and widespread riots. As the socialist regimes in Eastern Europe were collapsing at about the same time, President Kérékou renounced Marxism, released political prisoners, arranged free elections, and launched market-oriented economic reforms supported by the World Bank and—for the first time—an IMF program. A National Convention in 1990 established an interim government, a new constitution was approved by referendum, the country's name was changed to Republic of Benin and, in early 1991, multi-party elections led to a new government. The peaceful political transition—President Kérékou was the first leader in mainland Africa to lose power through elections—and economic liberalization stimulated foreign investment and a gradual economic recovery, although the country remains poor and dependent on subsistence agriculture. In 1991, according to the CPIA index, Benin exited fragility.

Cambodia

Since 1970, Cambodia, a small agricultural economy, experienced two decades of war, internal conflict, a genocidal regime, famine, invasion, and an international embargo. During this period, 2 million to 3 million people—about a third of the population—perished, physical infrastructure was destroyed, two-thirds of draught animals were lost, large areas of agricultural land were mined, and economic and judicial institutions were destroyed. A comprehensive peace settlement in 1991 and the arrival of the UN Transitional Authority in Cambodia (UNTAC) to enforce the ceasefire, deal with disarmament and refugee re-settlement, and organize the first post-war election in 1993 provided the basis for a return to normality. In 1994, some economic reforms were launched under IMF - and World Bank-supported programs to open the economy, control inflation, and strengthen the fiscal position. But the reform drive was short-lived as political turmoil continued. The Cambodian People's Party (CPP), in government since the Vietnamese invasion in 1978-79, refused to relinquish power and control of the armed forces. Tensions culminated in a coup d'état in 1997 that ousted the Prime Minister and consolidated power in the hands of the CPP. This led briefly to international isolation, cuts in foreign aid, and a setback for the emerging tourist industry which, combined with the regional effects of the Southeast Asian crisis, resulted in a major economic shock. However, after new elections in 1998 and a power-sharing arrangement with the CPP as the senior partner, the political situation stabilized. The CPP has dominated Cambodian politics since then, with current Prime Minister Hun Sen one of the longest- serving world leaders. Cambodia was admitted to ASEAN in April 1999, and the government engaged in a renewed effort to modernize the economy, improve governance, reform the civil service and the military, restore macroeconomic stability, improve tax collection, and mobilize resources for investment. Economic reforms were again supported by the IMF and World Bank. According to the CPIA index, the Cambodian state exited fragility in 2000.

Dominican Republic

The Dominican Republic entered a long period of economic decline in the late 1970s and, especially, the 1980s (the "lost decade") caused by three main factors: (i) persistent macroeconomic instability, reflecting chronic fiscal imbalances, large public enterprise losses, high inflation, and an overvalued exchange rate; (ii) a highly distorted incentive structure derived from an overly protective, arbitrary, and non-transparent trade regime, a multiple exchange rate system that penalized exports, domestic price controls and administrative impediments, a complex tax system, restrictive foreign investment rules, and widespread corruption; and (iii) financial repression and an unstable and inefficient banking sector. Economic reform efforts supported by the IMF and World Bank were half-hearted and short-lived, as popular unrest (notably in April 1984) or balance of payments crises (notably in June 1987) forced the government to backtrack. According to the CPIA index, the state was in fragile territory throughout this period. In 1990, the economic situation deteriorated further owing to a pre-electoral loosening of financial policies, a sharp deterioration in the terms of trade, and a drought, leading to a spike of year-on-year inflation to 80 percent, a widening balance of payments deficit, and external arrears, including to the IMF and World Bank. In August 1990, the government launched the "New Economic Program," a raft of reforms including fiscal consolidation, trade reforms to enhance the outward orientation of the economy, unification of the multiple exchange rates and a devaluation, liberalization of interest rates, and steps to strengthen the banking system. Refinancing and rescheduling agreements with the Paris Club (1991) and with private creditors (1994) resulted in a halving of public external debt, and a new foreign investment law (1995) led to a surge in foreign direct investment. Growth accelerated and inflation fell sharply and stayed in the single digits. International pressure after the flawed 1994 elections led to a new government in 1996, which reduced tensions with Cuba, introduced judicial reforms, and signed the Free Trade Agreement for Central America. Although economic volatility continued, the cumulative impact of economic and political reforms led to the Dominican Republic's exit from fragility in 1997.

Rwanda

Since independence in 1962, Rwanda had experienced tensions and recurrent bouts of violence between the Hutus and the Tutsis, the two largest ethnic groups. In 1990, the Tutsi-dominated rebel group Rwandan Patriotic Front (RPF) invaded from neighboring Uganda triggering a civil war, until a ceasefire and a power-sharing arrangement were agreed in 1993. However, the assassination of the Hutu President Habyarimana on April 6, 1994, triggered systematic reprisal attacks by armed Hutus against Tutsis (and moderate Hutus) coordinated by the government, in what became known as the Rwandan genocide. Over the course of approximately 100 days, between 500,000 and 1 million mostly Tutsi Rwandans were killed. The RPF re-started their offensive, eventually taking control of the country in mid-July. During these few months, in addition to the loss of life, about 2 million Rwandans fled to refugee camps in neighboring countries and another 1 million were displaced internally, out of a population of just over 7 million, while looting, destruction of infrastructure, and neglect of important cash crops added to the economic shock: real GDP is estimated to have declined by almost 50 percent as a result of the crisis. The RPF-led government, in power since 1994, has worked to promote justice and reconciliation (including through the establishment of the International Criminal Tribunal for Rwanda), encourage the return and re-settlement of refugees, and normalize political life. In addition, it launched reforms aimed at strengthening state capacity, de-mobilizing and re-integrating ex-combatants, establishing physical security, revitalizing agriculture, improving public resource mobilization and management, developing private sector activity, and diversifying the economy. Sustained flows of substantial foreign aid, including support by the IMF and World Bank, have helped the success of these reforms, with real GDP roughly tripling in the decade following 1994. According to the CPIA index, Rwanda exited state fragility in 1998.

Senegal

At independence, Senegal emerged with a stable and, by regional standards, relatively prosperous economy, as well as with good administrative and transport infrastructure centered around the capital, Dakar, one of the major cities of France's West African empire. Since then, Senegal has been spared the ethnic and religious strife and military coups that beleaguered other African countries, and has maintained one of the most stable and least repressive political regimes on the continent. Economic policy during the 1960s and 1970s was based on an inward-looking strategy and extensive state intervention, with public enterprises dominating not just infrastructure but also many manufacturing and service sectors. During the 1970s, economic growth was strong as a result of good rainfall and high world prices for groundnuts and phosphates, leading to a boom in public spending. But a succession of droughts and a deterioration of the terms of trade after 1978 resulted in rising fiscal imbalances and a steadily appreciating real exchange rate, given the fixed exchange rate between the CFA franc and the French franc. Reform efforts during the 1980s were unsuccessful, owing to weak implementation and frequent backtracking—partly due to the continued generous flow of foreign aid. In the early 1990s, the economy entered a severe recession and, according to the CPIA index, Senegal slipped into state fragility. An Emergency Plan in August 1993 failed to address the (by then massive) real exchange rate overvaluation, while the Plan's fiscal measures aggravated the recession. The situation turned in 1994, following a 50 devaluation of the CFA franc agreed with France and the other countries of the CFA franc zone. This was accompanied by a comprehensive medium-term adjustment and reform strategy aimed at containing the immediate impact of the devaluation on inflation while taking steps to liberalize trade, privatize non-strategic public enterprises and improve financial management in the rest, and strengthen domestic private sector incentives. Exports responded strongly, inflation was brought under control swiftly, external and domestic imbalances improved, and Senegal exited state fragility in 1995.

Viet Nam

The human toll and devastation caused by the Viet Nam war that ended with the unification of North and South Viet Nam in 1976, as well as the war with Cambodia in 1978-79 (which led to a US-led embargo) and a brief Sino-Vietnamese war in 1979, perpetuated widespread poverty and stagnation in Viet Nam's economy, which at that time was dominated by subsistence agriculture. Output growth re-started in the early 1980s but ran out of steam quickly, despite massive Soviet financial assistance, due to the central planners' emphasis on large industrial projects, collectivization, inefficient state enterprises, and excess money creation that led to hyperinflation (600 percent in 1986). According to the CPIA index, Viet Nam was a fragile state throughout this period. These failings were recognized by the Sixth Communist Party congress in December 1986, which launched the strategy of doi moi ("renovation"). During 1987-88, and especially in 1989-90, a wave of reforms created a Treasury and a two-tier banking system, opened the country to foreign investment, dismantled collective farms, encouraged private ownership in other sectors, unified the multiple exchange rates (effectively devaluing the domestic currency by some 70 percent), liberalized prices, established control over public spending (partly by demobilizing half a million soldiers), and removed trade restrictions. Despite the collapse of trade relations with the CMEA and the termination of Soviet financial assistance in 1989-90, the supply side— especially agriculture—responded strongly to the reforms. This, as well as the gradual coming onstream of oil production starting in the late 1980s, meant that Viet Nam—unlike other former socialist countries—went through a rapid economic transition without experiencing a drop in output: after a slowdown during 1990-91, GDP growth accelerated to 8-9 percent annually. According to the CPIA index, Viet Nam exited state fragility in 1989.