

# Capital Account Liberalisation and Poverty<sup>1</sup>

*Alex Cobham, Queen Elizabeth House, Oxford University*

## Executive Summary

This paper discusses the implications of capital account liberalisation (CAL) for poverty reduction in developing countries. The findings raise concerns about the predicted benefits. While theory implies there will be efficiency benefits for international finance, the existence of growth benefits for developing countries - of both short term flows and foreign direct investment (FDI) - has simply not been established by empirical research. Moreover, a variety of costs and a number of further potential dangers for countries liberalising their capital accounts in particular, and their domestic financial markets, have been identified. Many of these costs are associated not only with crisis periods, but also periods of capital inflow.

CAL may contribute to reduced levels and stability of government finances, and hence reduced provision for the poorest and reduced investment. In addition both CAL and domestic financial liberalisation may increase unemployment as finance is diverted away from rural areas and from smaller firms in search of higher investment gains. The implication is that the approach of the Bretton Woods Institutions (BWIs), requiring stronger supervisory and regulatory institutions - essential-

ly anti-crisis measures - will be insufficient to ensure that Capital Account and domestic financial liberalisation are beneficial to the poor. The massive costs to the poor of crisis periods - the combination of reduced levels of social expenditure, reduced levels of transfers, increased unemployment and reduced real wages - are most apparent.

The findings of this paper - the costs of both inflow and outflow periods, and the absence of proven growth benefits - have a number of substantial policy implications. First and foremost, the proponents of capital account liberalisation - most notably at the IMF - must recognise that the burden of proof is on them to establish benefits in terms of both poverty reduction and economic growth. The underlying assumption of a great deal of the BWIs' approaches, that there are benefits given the right initial conditions, must be seriously rethought until that proof has been provided.

The international institutions, and international policymakers more generally, must seek to assist in stabilising flows to developing countries and allowing macroeconomic policy flexibility if poverty reduction is to be achieved. Capital account liberalisation is simply not a priority in this context.

## Introduction

The key question in the current debate on capital account liberalisation and international financial integration is that of their impact on poverty. The problem for policymakers, both at the national level in developing countries and internationally for the multilateral institutions, is that the link between capital account liberalisation and poverty is far from clear. Despite the adoption of poverty reduction as a central objective by the Bretton Woods institutions, analysis of macroeconomic policy in terms of poverty impacts has yet to become a central approach.

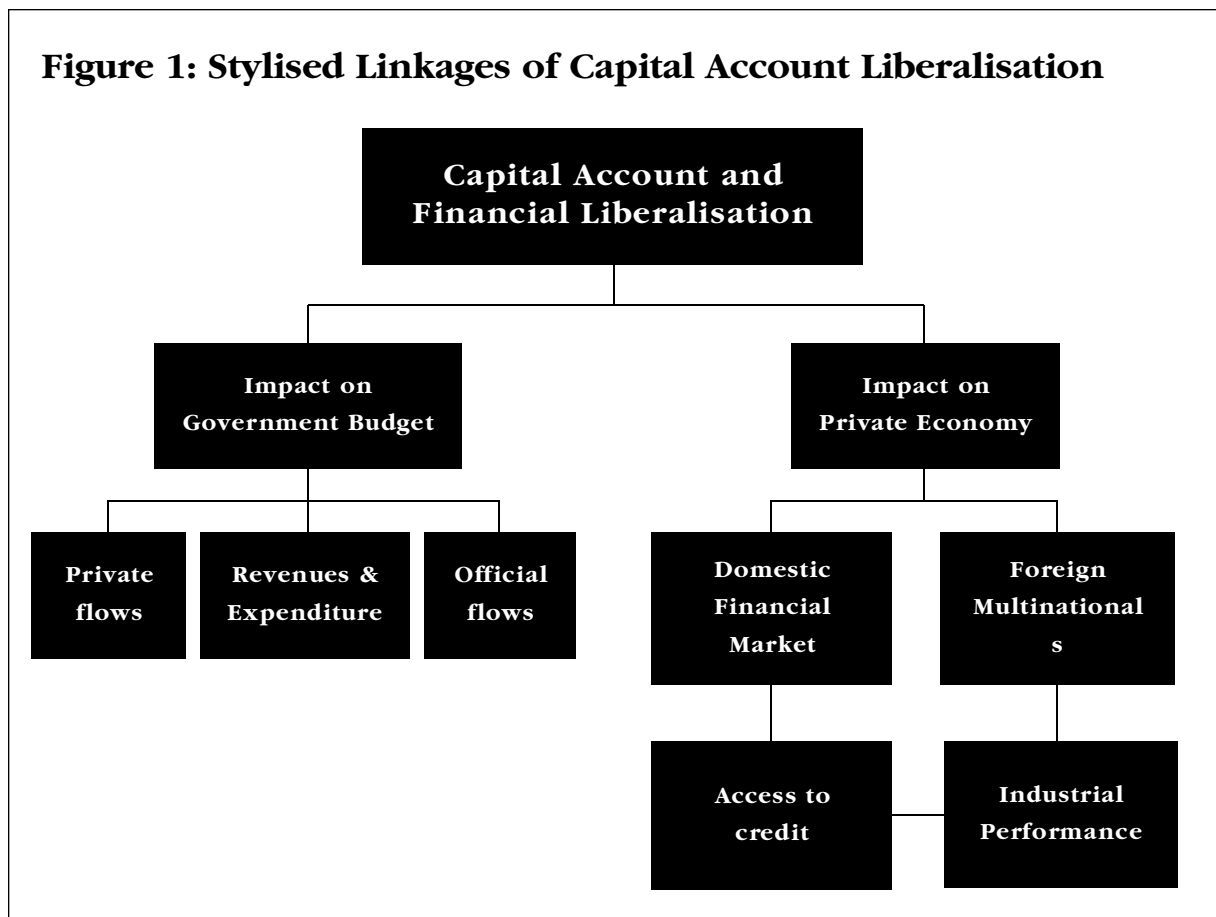
This paper sets out to assess the linkages between capital account liberalisation and poverty, with a view both to indicating areas in which further research is necessary and outlining some policy options for developing country governments.

The dominant view in policy circles, even with the recent more measured approach, is that any doubts about the benefits of capital account liberalisation can be addressed through careful policy

sequencing. Countries need to carefully manage and sequence liberalisation in order to minimise the risk of crises. The aim of this paper is to establish whether putting poverty considerations at the top of the agenda changes the established view of the benefits of liberalisation.

The paper is set out as follows. Section 1 surveys the considerable evidence on the growth effects of financial and capital account liberalisation, and notes the clear absence of proven growth benefits. Section 2 then describes some of the impacts of recent crises in the aftermath of liberalisation episodes. Sections 3 and 4 then consider the basic channels by which capital account liberalisation affects the poor during periods of capital inflow. Figure 1 shows the framework which will be used to follow the linkages through government finances and policy choices on the one hand, and through industrial and personal access to credit on the other. A number of serious potential costs of liberalisation are outlined.

**Figure 1: Stylised Linkages of Capital Account Liberalisation**



# 1 Financial and Capital Account Liberalisation

This section examines the growth impacts of financial liberalisation,<sup>2</sup> providing a background to the discussion on poverty impacts in the rest of the paper. The empirical literature is briefly surveyed, and the extent of capital account liberalisation in a range of developing countries is assessed. The section begins with some basic definitions.

## 1.1 Definitions and Interactions

**Financial liberalisation** involves the elimination of various forms of government intervention in financial markets: essentially allowing the market to determine who gets credit and at what price, i.e. financial liberalisation is the process of removing elements of ‘financial repression’. Key elements of domestic financial liberalisation (DFL) include: the elimination of credit controls; the deregulation of interest rates; free entry into the banking sector; bank autonomy; and privatisation of the banking sector. Proponents of domestic financial liberalisation have long argued that freeing the financial sector from government intervention is beneficial for economic development

because governments allocate credit less efficiently than the market.<sup>3</sup> It is also argued that under financial repression saving is constrained by the interest rate ceiling, which reduces investment and, in turn, growth.

**Capital account liberalisation (CAL)** is the process of removing restrictions from international transactions related to the movement of capital. It can involve the removal of controls on both domestic residents’ international financial transactions and on investments in the home country by foreigners. Liberalisation can apply to both inflows and outflows of capital. Capital account restrictions can take various forms including: limiting domestic banks’ foreign borrowing; controlling foreign capital coming into the economy; limiting the sectors of industry in which foreigners can invest, and restricting the ability of foreign investors to repatriate money earned from investments in the domestic economy. Table 1 presents a large, though not comprehensive, range of examples of controls, grouped according to this distinction.

**Table 1: Types of Capital Controls Used**

<b>Types of Flow to Domestic Economy</b>	<b>Controls on Inflows</b>	<b>Controls on Outflows</b>
<b>Portfolio - equity</b>	Forms: Blanket control, inflow tax (% of transaction value), minimum stay restrictions (e.g. Chile had a 12-month sliding scale of taxes until 2000) Intention: Reduce volatility, change maturity composition of inflows (towards longer-term).	Form: Blanket control - up to 100% tax. Intention: Last resort measure - prevent deepening of crisis, allow government maintain lower interest rates hence reduce damage to industry (investment).
<b>bonds</b>	Form: Restrictions on foreign holding (up to 100%). Intention: Reduce volatility.	As above.
<b>Direct investment</b>	Form: Investment boards Intention: Ensure integrity of national industry.	Forms: Profit repatriation restrictions, or reinvestment requirements. Intention: Ensure local economy benefits.
<b>Bank lending</b>	Forms: Reserve requirements on foreign borrowings - enshrined in Basle Accord (preferably reserves held in foreign currency). Intention: To remove risk of bank collapse precipitated by withdrawal of foreign credit (and remove exchange risk on forex borrowing).	As portfolio flows.

**Note:** Controls listed are as they apply to foreign capital flows. Domestic capital is also subject to the same controls, to reduce volatility and as a last resort measure in the same way, and also to prevent the flight of capital intended to avoid taxation or the detection of related crime.

The connection between domestic financial liberalisation and capital account liberalisation is a strong one. The two processes can be considered in terms of their interlocking and (potentially) mutually reinforcing effects on the economy. These effects can be separated into those affecting individual agents, and those affecting the financial system as a whole. First, the incentives for foreign investors to enter should increase after domestic financial liberalisation as returns tend to improve. This should also reduce the motivation for domestic capital flight.

Second, more efficient financial markets should lead to higher volumes, and better quality, of investment. This improves the performance of industries and the economy overall. Better economic performance (assuming trade liberalisation) should lead to greater trade integration, and hence a greater demand for foreign exchange and financial instruments denominated in foreign currency. This increases the need for full convertibility of the domestic currency.

Third, a prerequisite for CAL to be successful is a greater degree of domestic financial liberalisation. Allowing foreign investment in domestic financial markets calls for minimum levels of both market efficiency and institutional and regulatory capacity to safeguard stability. These stem from two

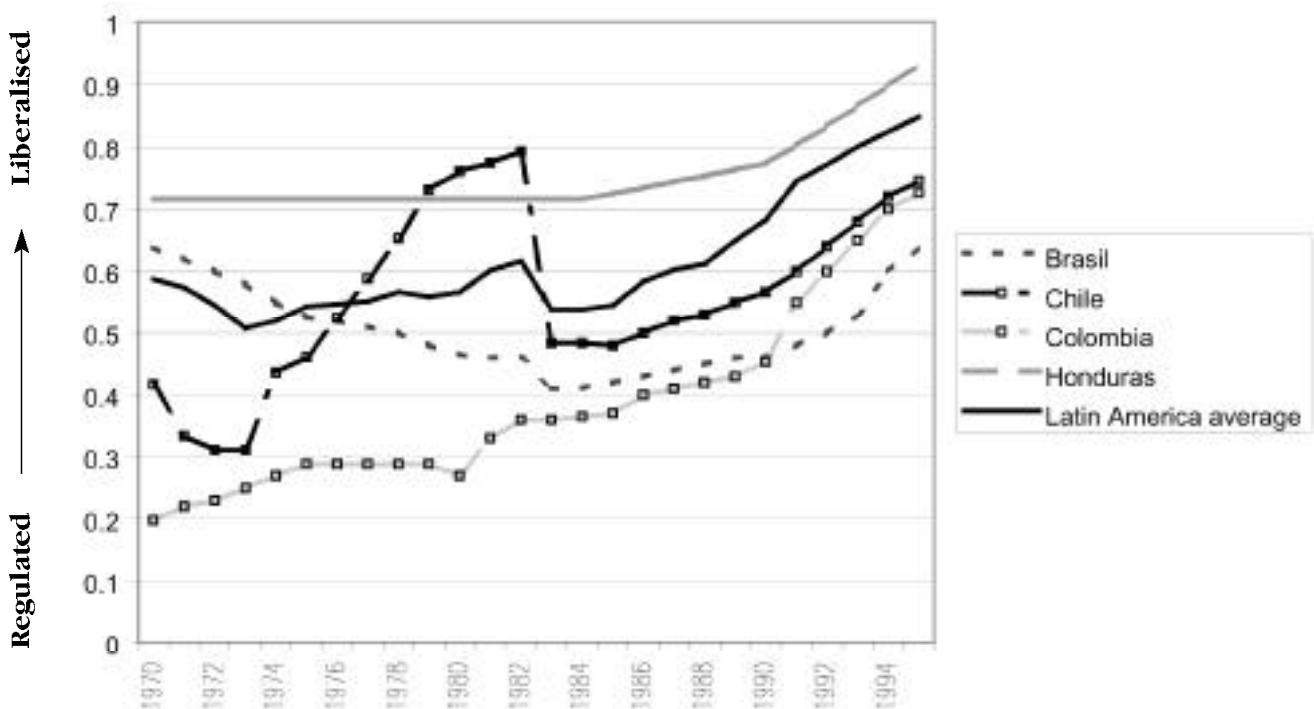
potentially destabilising effects: the competitive effect of entry by foreign financial institutions into the banking and Non Bank Financial Institution (NBFI) sectors, and the liquidity and volume effects of large foreign capital inflows to domestic equity markets. The sequencing literature is unanimous in scheduling capital account liberalisation after domestic financial liberalisation.

## 1.2 The Extent of Capital Account and Domestic Financial Liberalisation

Williamson & Mahar (1998) survey 34 countries (9 industrial and 25 developing), which have undergone some financial liberalisation in the period since 1973. The survey illustrates the extent to which financial liberalisation has been a dominant orthodoxy in recent decades.

Financial and other liberalisation was the pervasive theme of policy in Latin America during the period 1970-95. Figure 2 shows the capital account picture for some sample Latin American countries, indicating the considerable variation and periods of alternating liberalisation and repression. The Latin American average captures the fitful nature of liberalisation in the continent.<sup>4</sup>

**Figure 2: Some Capital Account Liberalisation Trends, Latin America 1970-95**



Countries in other regions have also seen considerable financial liberalisation over the past twenty years. Adam (1999:264) notes that “many African economies have undergone comprehensive reforms, in terms of... the liberalisation of markets (both for goods and [financial] assets)”, and notes that the process has been more far-reaching in Zambia, Ghana and Uganda while more gradual in Tanzania. Zambia’s capital account liberalisation was carried out at a stroke in 1994, after a period of domestic financial liberalisation. Kenya carried out significant financial liberalisation in the early 1980s, and suffered a serious banking crisis in 1986. Malawi’s financial liberalisation was largely complete by the early 1980s, while Uganda, Lesotho and South Africa followed in the mid 1990s. The Franc Zone had generally liberal markets from the 1980s. In the Middle East and North Africa, Egypt, Israel, Jordan, Lebanon and Turkey have substantial capital account convertibility, while Algeria, Morocco, Syria and Tunisia retain significant restrictions.<sup>5</sup>

India began a gradual financial liberalisation in the 1980s after nearly forty years of national industrialisation planning, and began a structural adjustment program in 1991. Reforms included the freer import of capital goods, removal of the restrictions against foreign equity holdings exceeding 51% and measures to attract FDI. China is following a gradual financial liberalisation path, although one that has been accelerated to meet the conditions imposed for WTO entry.

The East Asian countries have followed various patterns of financial liberalisation. Taiwan and Korea focussed heavily on FDI-attracting strategies in the 1960s and 1970s, although both countries retained significant controls on short-term flows and banking entry. Malaysia, Thailand and later the Philippines had largely liberalised finance and capital markets before the crises which hit the East Asian economies in 1997 and 1998. Singapore and Hong Kong had liberalised these some twenty to thirty years earlier.

There is now a vast empirical literature that attempts to measure the actual effects of financial liberalisation on growth. The key findings of this literature are discussed below while the poverty effects of liberalisation, which the literature has almost universally ignored, are detailed in later sections.

### **1.3 Growth Effects of Domestic Financial Liberalisation**

The clearest impact of domestic financial liberalisation is seen in changes in saving and investment rates due to the freeing of interest rates. Higher saving, and hence investment, should drive higher growth rates. The evidence for each is considered in turn.

In studies over a number of years (e.g. 1978, 1980, 1984, 1989, 1995) Fry finds that national saving is increased by higher real interest rates. However, the evidence of others is less conclusive. This seems to be primarily because DFL can equally drive increases in consumption (based on increased access to credit). In a number of countries, such as the UK, New Zealand, Turkey, USA, Argentina, Chile, Colombia, and the Philippines, there is evidence of a fall in the saving rate after recent liberalisation or deregulation episodes.<sup>6</sup> Mexico and Thailand also saw consumption booms.

However, Hussain (1996) finds that saving in Egypt increased by 6% of GDP per annum after DFL, while Schmidt-Hebbel et al (1994) speculate that the fall in Chilean saving may have been a short-term effect which was later reversed. Mosley (1999) finds that savings rates fell in Kenya and Malawi, rose slightly (became less negative) in Lesotho, and rose significantly in Uganda. Even if increased saving rates are accepted, the effects on investment rates are not at all clear. This is because two separate effects are unleashed by the removal of interest rate ceilings. While more saving should occur at higher interest rates so that the supply of funds for investment is increased, the concomitant increase in the cost of capital reduces the demand for investment funds.

Demetriades & Devereux (1992) find that the latter effect outweighs the former for a panel of 63 developing countries from 1961 to 1990. In other words, DFL and higher real interest rates can reduce investment (and hence growth). The most widely accepted view is that positive but reasonable real interest rates are the most conducive to investment and growth; and that DFL does not necessarily produce these.

Williamson & Mahar (1998) list Australia, Bangladesh, Chile, Malaysia, New Zealand, Sri Lanka, Taiwan, Thailand, Turkey and the US as countries having experienced sharp increases in rates

after DFL; while rates fell in others, including Israel, Italy and the UK. There is no clear positive impact of DFL on the volume of investment. The implication is that the benefits are driven by the resulting increase in financial development, that is, the efficiency with which the financial sector mobilises savings on the one hand and allocates capital for investment on the other. Recent studies by World Bank staff provide robust evidence of a link between GDP (or GDP growth) and levels of financial development.<sup>7</sup> What is missing from this work, however, is any convincing evidence of causality (and higher growth/higher GDP countries would be expected to undergo a process of stronger financial development). Jung (1986), finds evidence of causality in both directions.

While the exact mechanism through which financial development impacts growth has not been empirically investigated in detail,<sup>8</sup> the preferred view is that the positive impact stems mainly from gains in market efficiency rather than volume of funds – increases in the quality rather than the quantity of investments.<sup>9</sup> The impacts of DFL on credit allocation by sector of industry, and on investment by firm size, are detailed in section 3. However, the evidence suggests that improved efficiency of markets and hence investment is the key benefit of financial development through liberalisation.

#### **1.4 Growth and Capital Account Liberalisation**

It is useful to distinguish more clearly between different types of capital flow: between foreign direct investment (FDI); foreign portfolio investment (FPI), consisting of equity flows and bond flows;

and foreign bank lending. Briefly, FDI is by its nature the least easily reversible, short-term bank lending the most vulnerable to reversal, while portfolio investment (especially equity flows) can also exhibit high volatility. Table 2 illustrates the relative volume of these flows.

FDI has tended to concentrate on relatively few regions (China, East Asia and Latin America) – ten countries host three-quarters of the flows to developing countries. However, if we take into account the relative size of the host countries, we find that as a share of gross domestic product or fixed capital formation, the ratios for FDI in Sub-Saharan Africa are similar to those for Latin America and actually higher than the ratios for Asia. Portfolio investment and bank lending do seem to be biased towards middle-income rather than low-income countries, even when market size is taken into account. This reflects in part the under-development of capital markets and bank sectors in poorer countries.<sup>10</sup>

Literature on the growth effects of capital account liberalisation is ambiguous. On the linkages between freeing up of capital account regulations and long-run economic growth, Quinn (1997) remains the only work to find a benefit to removing controls. Levine & Zervos (1998) find no evidence of long-run effects on the growth of the capital stock (which would be expected to yield a higher long-run economic growth path). Klein & Olivei (1999) do find that open capital accounts have an effect on financial deepness and, through this channel, on economic growth. They make the standard argument that through a more efficient market, which reduces problems of asymmetric information and transaction costs, a greater volume of savings is mobilised to more productive purpose. They do not, however, draw the conclusion from these

**Table 2: Value of Capital Flows to Developing Countries, US\$bn**

	1991	1992	1993	1994	1995	1996	1997	1998
Net private capital flows	123.8	119.3	181.9	152.6	193.3	212.1	149.1	64.3
Net direct investment	31.3	35.5	56.8	82.7	97.0	115.9	142.7	131.0
Net portfolio investment	36.9	51.1	113.6	105.6	41.2	80.8	66.8	36.7
Net bank lending*	55.6	32.7	11.5	-35.8	55.0	15.4	-69.4	-103.4
Net official flows	36.5	22.3	20.1	1.8	26.1	-0.8	24.4	41.7
Changes in reserves	-61.5	-51.9	-75.9	-66.7	-120.2	-109.1	-61.2	-34.7
Current account balance	-85.1	-75.6	-116.0	-72.0	-91.0	-91.8	-87.1	-59.2

Source: FitzGerald, 1999.

\* denotes 'other net investment' in the original source table (IMF, 1999).

findings that capital account liberalisation in developing countries yields growth benefits.

This is because they do not find evidence of the same effect in countries which are not members of the OECD. In other words, the finding does not hold for developing countries. Klein & Olivei attribute this to the absence in developing countries of the necessary economic, legal and social institutions. This approach is consistent with the sequencing arguments, as well as with the findings of King and Levine (eg. 1993), and would appear to lend support to the G7's codes and standards-based approach to the reform of the global financial architecture.

Further interesting findings on the impact of capital account liberalisation can be found in a paper by Kraay (1998). Kraay first confirms the absence of evidence of the growth benefits of capital account liberalisation, and then investigates two common interpretations. First, and in line with the arguments detailed above, he considers the view that the benefits will only be obtained by countries with sufficiently 'good' policies and institutions. This he dismisses on the basis of a number of econometric analyses.

Second, Kraay examines the view that the growth benefits of capital account liberalisation are obscured by the costs of associated volatility. This, too, he dismisses, finding that there is little evidence that volatility of capital flows is significantly higher in financially open economies. However, the result does not allow for initial levels of financial development. It therefore ignores the relatively greater impact of volatility on countries where the corporate, and particularly the financial, sectors are relatively weak or underdeveloped.

Durham (2000a,b,c) attempts to assess the difference between middle-income (MICs) and low-income countries (LICs) in terms of the impact of capital account liberalisation. In the first (survey) paper, he notes that an important and obvious but nevertheless largely omitted variable in econometric work has been the initial level of financial development. In particular, he suggests the existence of 'threshold' levels of financial development which may have to be reached in order for the gains from liberalisation to be felt.

Durham draws the following conclusions in the second paper:

- | FDI has an ambiguous effect on growth
- | FPI has a generally negative impact on long-run growth. Distinguishing between MICs and LICs on the basis of initial financial development, and between equity flows and bond flows, he concludes that:
  - (i) for higher levels of previous stock market development (i.e. for some MICs but no LICs), volume of equity flows are more likely to be positive for growth;
  - (ii) volatility of equity flows is negatively correlated with growth in all cases;
  - (iii) net bond flows and net equity flows have no impact on domestic savings rates.

These results certainly imply support for the proposition that some countries (i.e. the LICs) do indeed have financial sectors too underdeveloped to liberalise their capital accounts. However, there is also a lack of significant support for liberalisation in middle-income countries. Durham (2000c) concentrates solely on the effects of stock market development on investment and growth. As in the work of Klein & Olivei, he finds that it is higher income countries which drive the overall positive relationship between stock market development and growth.<sup>11</sup> Initial GDP and country credit ratings are significant, which implies that the gains accrue to already wealthier countries. Moreover, the increased investment and growth benefits of equity flow liberalisation are present to an extent in some middle-income countries, but cannot be observed in lower income countries.

It must be concluded on the basis of this literature survey that the growth-related benefits of capital account liberalisation for developing countries have not been established. Indeed, since there is a significant body of work which has searched for effects, it is more accurate to say that these results have not been observed and may not exist at all. This goes against the conventional wisdom behind the approach of the Bretton Woods Institutions: namely that the benefits of liberalisation will accrue to those countries who follow the right policies, and who have the right institutional and supervisory standards in place. This view is in fact specifically refuted by the work of Kraay.

The major concern is that not only do the

growth-related benefits of liberalisation appear to be non-existent, but also that liberalisation may have significant costs and those costs may be most strongly felt by the poorest groups. This paper now focuses on the impact of capital account liberalisation on poverty. In particular, the impact on the volatility of the domestic economy is examined as it is in this area that the costs of liberalisation can be most easily observed. Instability in both the

areas of government finances and private investment may be caused not only by the day to day volatility of capital flows, but also by the potential for sudden and massive outflows. The latter conditions and restricts the behaviour of both governments and the private sector. Their behaviour is detailed in sections 3 and 4 respectively, but the following section focuses on the impact of crises which have often followed liberalisation episodes.

## 2 Crisis Periods

The clearest costs of financial liberalisation occur in the form of macroeconomic crises, which have grave consequences, especially for the poor. There is a considerable literature showing that domestic financial liberalisation episodes have been consistently followed by financial crises.<sup>12</sup> Capital account liberalisation brings further risks as the economy is opened to considerably more volatile flows, and the potential for the banking sector to become dangerously overexposed is extended.

Casual observation suggests periods of capital inflow are frequently followed by banking, currency or twin crises. Glick & Hutchinson (1999) analyse these events in 90 countries between 1975 and 1997. They find that twin crises are concentrated in the group of financially liberalised emerging market countries (ie MICs), and that the power of banking crises to trigger currency crises is most marked in this group. The costs in economic terms can be extremely high; Singh & Zammit (2000) put the cumulative cost of twin crises as high as 18% of GDP lost in each case. A number of crisis episodes were identified and studied in the consultation draft of the World Bank's *World Development Report 2000*:

- | Jordan, 1989 (real GDP fell 13.5%);
- | Argentina, 1995 (per capita GDP fell 4.2%);
- | Mexico, 1995 (per capita GDP fell 8.1%);
- | Thailand, 1997 (average real GDP fell 10% in 1998 alone);
- | Indonesia, 1998 (GDP growth rate fell from 4.5% in 1997 to -14.3% in 1998);
- | the Philippines, 1998 (real GDP turned around from 5.2% growth in 1997 to -0.5% in 1998).

The impact in terms of social indicators has been at least as great. This section describes the channels through which crises affect the poor. The main channels explored, following the general approach of the paper, are through government finances on the one hand, and industry and personal access to credit on the other.<sup>13</sup> Through the first channel, the socialisation of private debt is considered separately from the general macroeconomic policy response. Both are seen to have potentially large costs.

### 2.1 The Socialisation of Private Debt

Where developing countries face crises in their financial sectors, they generally fall into one of two categories. In the case of low-income countries, banking crises after financial liberalisation characteristically involve the problem of bad loans, where the balance sheets of banks and other financial institutions are overwhelmed to the point of insolvency. In the case of higher-income countries, the financial sector often encounters difficulty when it has become dependent on continued access to foreign capital to maintain its activities. Problems come to the fore following a re-evaluation of the sector's prospects by the suppliers of this capital, or alternatively following a large change in the exchange rate.

In both these scenarios, governments have very strong incentives to step in and ensure the continuing operation of the financial institutions. Whether in the case of Kenya's banking crisis in 1986, the East Asian crisis or indeed the United



States' bail-out of the Long Term Capital Management (LTCM) hedge fund, governments have been forced to act in order to minimise the damage to the sector, as well as to the real economy by transmission. The implicit (or in some cases explicit) guarantees provided by governments to the banking sector and large corporations can result in vast costs for governments. These costs are ultimately borne by the country's citizens and, in some cases, by donors.

The scale of banking sector rescues has become daunting in recent years. In Korea, for example, the authorities spent some US\$50bn on recapitalising banks following the recent crisis. The figures for Indonesia and Thailand were around US\$70 billion and US\$20 billion respectively (World Bank, 2000). Banking rescues of this kind, provoked by the need to prevent systemic banking crises, can increase the moral hazard problem. Since investors (rightly) judge that certain groups and companies will not be allowed to go bankrupt, and hence the costs of failure will be largely borne elsewhere, they have an incentive to continue lending even when they judge the recipients to be highly risky.

As it is the recipient countries, rather than the investors, that bear the costs of rescues, moral hazard ultimately leads to a drain on taxpayers and multilateral donors.<sup>14</sup> The impact on government spending – at a time when the economy is at its weakest, and the need for a public safety net greatest – is to reduce greatly the proportion available for social expenditure. Buch & Heinrich (1999) examine the Russian crisis that began in August 1998, and recommend that recapitalisation should be carried out by foreign investors rather than governments, to limit moral hazard problems. Banks which cannot attract funds should be closed (despite the possible short-term costs of reduced access to credit for domestic industry), and governments should take control from previous shareholders to facilitate the hand-over and minimise asset-stripping.

As noted above, the economic costs of crises can be very high. World Bank researchers Honohan & Klingebiel (2000) identify 40 banking crises in developed and developing countries, and show that the cost for nine of these exceeded 15% of GDP: Chile and Uruguay (1981), Cote d'Ivoire (1988), Japan (1992), Slovakia (1992), Mexico and

Venezuela (1994) and Korea, Indonesia, Malaysia and Thailand (1997). Indonesia, Chile, Thailand and Uruguay exceeded 30%. The average cost across the 40 cases was 12.8% of GDP.

Despite the high costs, governments cannot escape the need for intervention in some cases because of the potential negative impacts on domestic industry. The intervention by the US authorities in the LTCM hedge fund case shows how this is still true for countries with highly developed financial sectors. This gives some indication of how impossible it would be for poorer countries with much more concentrated banking sectors to withstand banking collapses without intervening. The need to maintain some level of access to credit for domestic industry is great, to combat as far as possible the real economy effects of financial crisis. The real economy costs are dealt with below, but first we turn to other aspects of the policy response.

## **2.2 Macroeconomic Policy Response**

UNCTAD (2000) notes that “although the [East Asian] crisis in each country had its own characteristics, there is little doubt that extremes of collapse and recovery have, in large part, been due to misguided policies” (p.vi). UNCTAD argues that contractionary monetary policy, essentially the imposition of high interest rates, that was designed to stabilise currencies not only failed to do so but also seriously exacerbated the negative output and employment shocks. UNCTAD stresses that the raising of interest rates actually proved to be much more damaging than currency depreciations themselves, and caused severe dislocations in the corporate and financial sectors. Domestic industries were unable to borrow at a critical time, leading to their further dilapidation.

The use of tight monetary policy, designed to protect the currency, was one key element of the International Monetary Fund (IMF) policy response in the crisis-hit countries of East Asia. Perhaps more damaging, though, was another main plank of IMF policy advice, that of reducing government spending. Fiscal tightening was seen as essential to regain the confidence of investors and ensure a speedy recovery of foreign capital flows.

These objectives, however, need to be weighed against the both the immediate effects on social spending and the longer-term impacts on economic structure and social indicators. Social investment funds were used as a vehicle to ensure some most basic provision of social support, and social safety nets were expanded in all the East Asian crisis-hit countries. However, in light of soaring unemployment these measures were clearly inadequate.

Fiscal contraction required spending cuts in general programmes. In Brazil, the federal government agreed with the IMF to reduce the fiscal deficit from 8% to 4.7%. This included a reduction of expenditures of \$7bn, of which more than 10% fell on priority social spending programmes. Indonesia reduced health expenditure by 8% in 1998 and 12% in 1999, and education expenditure by 41% in 1998 (rebounding by a third of this drop in 1999). Korea and Thailand seem to have been relatively well able to protect their primary health-care spending, and at least maintained social spending as a percentage of GDP, although national income had fallen (World Bank, 2000).

Notwithstanding the immediate impacts of cuts in the areas of education and healthcare, there are perhaps more damaging social and structural impacts. The rupturing of the long-standing entente between government and the workforce in Korea will have consequences long after even poverty indicators have returned to their pre-crisis levels. The 'fire-sale' of profitable, well-performing public utilities in Thailand to reduce the budget deficit and meet loan conditionality will have long-standing structural implications for the economy, for government finances and hence for the poor.

In the crisis episodes detailed above, the policy responses appear to have been primarily focused on external factors, such as maintaining the presence of foreign capital, rather than being driven by the needs of the domestic economy. In particular, the policy of fiscal tightening while social needs expanded seems counter-intuitive. The socialisation of private debt has the impact of relatively protecting large (foreign) investors. At the same time, the macroeconomic policy mix has tended to penalise, at least in the short term, domestic, and especially smaller, businesses. The impacts on industry are detailed below.

## **2.3 Real Economy Impacts**

In Korea, where the socialisation of private debt involved massive costs and policies were insufficiently focused on the needs of domestic industry, Ferri & Soo Kang (1999) show how small and medium-sized businesses suffered unduly from a credit contraction. This combined with the policy of high interest rates to price the remaining available credit out of reach of the smaller firms and ensured that the financial crisis passed onto businesses and society.

Between October 1997 and April 1998, Korea's unemployment rate more than tripled from 2% to 6.7%.<sup>15</sup> For those still employed, nominal wage growth fell from 11.6% in the first quarter of 1997 to zero in the corresponding quarter of 1998, while real wage growth then fell from 6.9% to -8.9%. Over the same period, inflation almost doubled from 4.7% to 8.9%. As a result, urban poverty tripled to 23% by the third quarter of 1998, and remained at double pre-crisis levels one year later (World Bank, 2000). The number of people in absolute poverty in Korea also tripled as a result of the crisis.

In Thailand, Chomthongdi (2000) reports how high interest rates increased the damage to industry, leading to the closure of up to one thousand businesses a month, with the negative knock-on effects for employment. At the same time, the closures also reduced consumption and further flattened demand, prolonging the recession. Private investment fell by almost half in 1998, as the economy worsened. Indeed, the pattern throughout the region was one of falling investment while consumption was relatively protected (World Bank, 2000). The longer-term implications for the rate of recovery and future growth rates are particularly worrying.<sup>16</sup>

Households were affected by lost employment as well as by a number of other factors. On the one hand, higher-income households lost out through the erosion of value of their larger assets: real estate and shares. Relative price changes had broader impacts. Currency depreciation on the whole increased the price of tradable goods, most notably agricultural produce, and so net producers - i.e. those of the rural sector who produce more than they consume - benefited. However, the urban poor and rural workers as net consumers lost out.

Whether access to credit, for businesses as well as for households, can be ensured efficiently through government intervention is not clear. For businesses, Ferri & Soo Kang at the World Bank recommend that “policymakers may want to provide relief - possibly through market-based actions... to make bank loans available to healthy firms in sectors (such as exports) on which recovery depends” (1999). If the priority is redefined as maintaining employment during a crisis, as much as pushing the recovery afterwards, then a different set of (nonetheless healthy) firms may be targeted. For households, the question of access to financial services for the poor is examined further in section IV. More research would be needed to identify types of program which could operate with most impact on the poorest, thus making best use of restricted government funds.

## **2.4 Some Conclusions**

This section has outlined briefly some of the clearest costs associated with post-liberalisation financial crises. Crisis response policies appear to have been focused on encouraging an externally-led recovery, rather than on domestic stabilisation in terms of employment and investment in industry. Such prioritisation may have been ill-judged. The economic and social costs associated with crises, and the key elements of policy detailed in this section, are clearly very high. There is also a pressing need for research into the types of measures that could help ensure the flow of credit to smaller businesses and poorer households during crisis episodes.

Proponents of financial and capital account liberalisation would argue that the benefits associated with capital inflow periods would outweigh the costs associated with crises. This paper will now turn to the poverty impacts of capital inflow periods.

## **3 Impact on Government Finances and Policy**

This section examines the effects of capital inflows on poverty through induced changes in government budgets and macroeconomic policy. Full capital account liberalisation in low-income countries involves allowing not only foreign direct investment, but also capital inflows to bond and equity markets and to the banking sector. These inflows can create serious restrictions on government policymaking. Two different effects can be discerned. First, government finances can become constrained by the cost of managing inflows as well as by the need to satisfy the market view of fiscal prudence. Second, increased levels of macroeconomic instability can impact on government revenue sources, with implications for government expenditures. This section will begin by considering the general position of developing country government finances before beginning to assess the effects of liberalisation.

### **3.1 Government Finances**

Reductions in government income will involve spending cuts that can have significant costs for the poor. Biggs (1998) shows that fiscal cutbacks in developing countries have historically targeted investment most heavily, while providing relative (but far from complete) protection to wages and transfers. Reduced infrastructure investment contributes to poor economic performance, while lack of institutional strength reduces governments' ability to raise taxes effectively. There are both short and long-term impacts on health and education provision when government spending (investment and recurrent) on these sectors is reduced.

Most direct for the poor will be the effect of even the disproportionately small cut in transfers. Despite the relative protection afforded to this category of spending, the impact may be great nonetheless, since transfers to the poorest will form a very great part of their total incomes.

These are incomes they can already ill afford to see cut. Clearly, the impact of reduced levels of government finance will hit the poorest groups hardest. It is not only reductions in spending that have costs, however, but also reductions in the stability of government finances.

Since government revenues are volatile, their ability to commit to programmes of expenditure is undermined. As well as undermining the stability of those who rely on transfers to attain some minimal standard of living, it also reduces the ability of governments to attract complementary private investment, hence reducing their overall potential to assist development. Toye (2000) details the relative instability of various sources of finance. Most unstable is aid, and recent evidence shows that aid flows have been not only volatile but also strongly pro-cyclical.<sup>17</sup> The most stable source of government finance has been through debt and money creation. Arguably, given the observed failure of aid to assist in smoothing government expenditures, these are the only stability-enhancing tools available to governments. However, money creation has significant inflationary consequences, and inflation has costs for the poor in particular because of their inability to acquire 'inflation-proof' assets.

This leaves debt as the sole most effective tool for governments to smooth their expenditures and protect the poorest. Capital account liberalisation opens domestic bond markets to international investors, and hence allows greater liquidity for governments and also domestic corporate bond-issuers. The ability of governments to raise additional finance through bond issues, however, is subject to the market discipline and fiscal policy issues which are discussed below.

The remainder of this section concentrates on explaining how both the level and stability of government finances are negatively affected by capital account liberalisation. It is worth pointing out here that the discussion that follows does not assume that governments, if unrestrained by liberalisation, will necessarily follow efficient pro-poor growth strategies. However, it seems uncontroversial to assume that having stronger and more stable finances will allow governments greater freedom to adopt such a strategy if they choose.<sup>18</sup>

### **3.2 Managing Capital Inflows**

The most direct route through which capital account liberalisation reduces the overall level of government budgets available for fiscal expenditure is by diverting expenditures to other avenues; in particular, managing the associated capital inflows. As Henry (2000) showed, liberalisation is a significant factor in triggering equity flow booms. Liberalisation may also result in increased bond, bank and (possibly) direct investment inflows. These inflows, and most especially the short-term flows which are less stable, put upward pressure on the domestic exchange rate because investors purchase local currency to invest in the stock market. To prevent exchange rate appreciation - which raises the cost of exports and lowers those of imports, and can thus reduce domestic production damagingly - the government must sell domestic currency and buy the incoming foreign exchange, thereby building up their reserves of foreign currency.

This would increase the domestic money supply by the amount in question, however, leading to inflationary pressures and associated problems, so a common next step is to sterilise the inflow. This is achieved by selling the equivalent value of government bonds to return the money supply to its original level and prevent the emergence of inflationary pressure. This counteracts the money supply expansion because selling bonds involves taking domestic currency in exchange, and hence reduces the available money supply - which in turn reduces the impetus for prices to rise.

The government has in effect increased its liabilities - in the form of bonds issued - but also increased its assets by the same amount, in the form of foreign exchange reserves. Assuming these reserves are held as interest-bearing assets, commonly US Treasury bills, the government has not necessarily worsened its position. However, the price to the government of these manoeuvres - omitting transactions costs - will in fact depend on the interest rate differential between the developing country and (in this case) the US rate.

Stiglitz (2000) gives the following example. If a company in the developing country borrows \$100m from a US bank, then since it is perceived as relatively highly risky, it must pay 20% interest. If the government holds foreign exchange

reserves (in US T-bills) to offset this borrowing, it receives 5% interest. The annual cost to the poor country of this arrangement is then \$15m. The cost to the government, if it is carrying out full sterilisation, may be different. If the government has sold bonds to the value of \$100m, to maintain a stable money supply, and – being relatively risky, but less than the company in question – pays 15% on this debt, the direct cost to the government is \$10m a year.<sup>19</sup>

While this is the value in foregone fiscal expenditure, the actual cost in foregone investment may be greater given that efficient government investment would also have levered in private investment. The effect of the capital inflows is to seriously reduce the level of government expenditure. Moreover, since reserve accumulation – and hence the current and future level of government expenditure – must react to volatile short-term flows, there is a further price to pay in terms of increased uncertainty of government finances.

To compound these costs of sterilisation, the widely-held view (with regard to industrialised countries at least) is that it cannot be successfully operated as a long term policy. This is because the inflows are generally the result of an interest rate differential between the domestic and international markets. Sterilisation, involving the issue of more bonds (presumably at the same or a higher interest rate to ensure demand) will not address this problem and may exacerbate it, and therefore cannot be a long-term solution. One other negative impact of sterilisation is that – as has been observed in many, especially African, developing countries – government bond issues dominate the market to the exclusion of other issuers except the largest corporates. In other words, following a policy of sterilisation may exacerbate the problems of domestic industry in raising debt financing for investment.

Alternatively, governments applying the IMF's Monetary Programming model may be focussing policy on preventing a depreciation of the exchange rate (Khan and Huq, 1990). This desire stems from the associated inflationary pressure: firstly imports become more expensive, and secondly cheaper exports increase the foreign demand for domestic production which in turn drives up domestic prices also. Governments will therefore be holding monetary policy tight (reduc-

ing deficits or building up surpluses in the budget) to combat inflationary pressures. Autonomous inflows (of foreign capital) reduce the downward pressure on the exchange rate and allow a relaxation of monetary policy (and hence increased growth), while outflows increase downward pressure and require a monetary contraction.

While this appears to represent a beneficial response to inflows, there are obvious costs. Policy will necessarily follow the cycle of foreign capital flows, which have been seen to be highly pro-cyclical with countries' economic conditions, rather than acting to stabilise the economy. In this scenario then, this model encourages pro-cyclical government policy – increased spending in booms, and cutbacks during recessionary outflow periods – and hence increased macroeconomic volatility. Whether the aim of government policy is to prevent an appreciation or a depreciation of the exchange rate, the management of capital inflows has costs in terms of increased instability of government finances and the macroeconomy more generally, and also of reduced expenditure under the sterilisation case at least.

### **3.3 Market Discipline**

The second key channel through which capital account liberalisation affects the level and stability of government finances is the mechanism of market discipline. The concept of market discipline reflects the sensitivity of investors to certain government policy variables. In theory, governments “are ‘forced’ to have good economic policies, lest capital flow out of the country” (Stiglitz, 2000, p.1080). Although Stiglitz does not make the distinction, ‘good’ policies are those investors perceive as consistent with strong investment returns. In practice, since investors base their decisions on only a very narrow range of information, changes in the level of governments' deficits, inflation (or expected inflation) and short-term indebtedness ratios in particular, can lead to very rapid adjustments of investors' portfolios. This apparent myopia is in part determined by the evaluation methods of the influential international credit ratings agencies.<sup>20</sup>

For a developing country with a liberalised capital account, the resultant changes can involve

inflows or more particularly outflows of great magnitude relative to the total size of the economy. The importance of avoiding such recession-inducing flows therefore ties the hands of government in important areas of macroeconomic policy. Market discipline acts as a deterrent against allowing high levels of inflation or running fiscal deficits. Countries which maintain significant controls on short-term flows, by contrast, can use countercyclical macroeconomic policy to smooth recessions and reduce macroeconomic volatility. China is just one example.

It is interesting to draw out two implications of the above discussion. First, rather than preventing fiscal excesses, market discipline in developing countries may prevent the efficient use of resources and pro-poor fiscal policy. If fiscal deficits are used by (some) developing countries to efficiently promote investment and protect the poor, the market discipline of capital account liberalisation will reduce the ability of these governments both to crowd in private investment and to target the poorest of their citizens through a social safety net. In other words, capital account liberalisation will have negative poverty effects both directly, through government expenditures, and indirectly, through reduced investment and growth.

On the other hand, where governments are using fiscal deficits inefficiently, the market discipline effect of liberalisation will be to curtail the wasteful use of limited resources. While there may be no direct poverty effects of this, crowding out of private investment by inefficient government expenditure may cease, with concomitant positive effects for investment quality and hence growth. This interpretation is supported by Kraay's (1998) finding that capital account liberalisation has benefits only for countries with bad policies or institutions - ie that market discipline may prevent the adoption of good policies.

### **3.4 Taxation and Capital Mobility**

Two further avenues through which capital account liberalisation can affect government finances and poverty are capital mobility and taxation. Most obviously, the associated macroeconomic volatility may make tax revenues increasingly variable because of the instability of under-

lying output, employment and investment. Three further areas of concern are the potential for capital flight after the removal of controls, the impact of increased capital mobility on the incidence of taxation, and the effects of tax competition between countries. These are treated in turn.

Capital flight may be defined as the transfer of funds out of countries motivated by domestic economic and political uncertainty (Schineller, 1997), but is often used to refer to all flows from capital-scarce to capital-abundant economies. Strictly defined, flight ought to involve illegal and undeclared capital movements, and there is an extensive literature detailing attempts to measure these flows.<sup>21</sup> This paper is concerned with the effect of removing controls.

Doolley & Kletzer (1994) find that when domestic financial markets are liberalised, and it is known that outward flows will not be unduly restricted, large amounts of domestic flight capital tend to return to seek investment opportunities at home. The actual effect of capital account liberalisation on capital flight may be generally positive then in increasing domestic investment by domestic capital-holders. However, other factors are also clearly important. Even the case of Uganda, where the 1997 liberalisation has been seen as beneficial - particularly due to the return of flight capital - it is clear that the improvement of conditions for investors was the driving factor.<sup>22</sup>

Another concern is the impact of increased capital mobility on taxation. To encourage inflows and avoid inducing capital outflows, governments have an incentive to tax capital less. If tax revenues are to be maintained, this may mean that the tax burden falls more heavily on workers and consumers, as the less mobile factor. This would have regressive distributional consequences. The (relative) reduction of taxes on capital is in effect a reduction of taxes on those with greater wealth. Moreover, higher tax on labour affects the poorest most heavily. The income of the poor derived from work forms a proportionately larger part of their total income, compared with owners of capital. The very poorest may be protected to the extent that they are not in fact part of the formal economy, and hence unaffected by changes to the taxation system. However, changes which increase the burden of taxation on labour will inevitably increase the disincentive for the poor to move

into the formal sector.<sup>23</sup>

Finally in this section, we turn to tax competition between developing countries for capital flows, and in particular for FDI. Many developing countries – particularly the smaller ones – attempt to attract foreign investment through tax incentive policies in an attempt to compensate for local distortions and inefficiencies, or to simply prevent foreign investment from going to neighbouring or similar countries. However, such incentives play a limited role as determinants of foreign investment, and even where successful – e.g. in some export promotion zones – involve significant fiscal costs.<sup>24</sup>

Studies have shown that tax competition between industrialised countries for foreign direct investment can result in the benefits of the investment being obtained by the multinationals.<sup>25</sup> This problem is even more acute in poorer countries, as the level of direct investment will be more sensitive to the tax rate in a small developing country than in a large industrialised country (or bloc of countries). This is because the cost of ignoring one developing country is small for the multinational.

While foreign direct investment is acknowledged as the most positive form of capital flow to liberalise, agreement on tax and subsidy competition is necessary to ensure some of the benefits accrue to the host countries and that tax revenues are not unduly undermined. Only a universal agreement, involving both developing and industrialised country governments, can ultimately solve the problems of harmful tax competition.

While tax competition to attract foreign portfolio investment does not occur in the same way as for FDI, it does exist in different forms. This involves deliberate government measures to facilitate the use of tax havens or tax loopholes to encourage the entrance of foreign portfolio and

banking flows. For example, the Bangkok International Banking Facility (BIBF) in Thailand has been used to funnel low-tax capital into the country. The BIBF was particularly heavily used in Thailand's post-crisis 'fire-sale' of domestic assets to international investors. Another example is in India, where Mauritius is used as a tax-avoiding point of entry to the country's capital markets.

### **3.5 Some Conclusions for Government Finance and the Poor**

Capital inflows (especially short-term) lead to particular problems for government finance. Through the management of capital inflows, the associated market discipline, and changes in the ability of governments to raise tax, both the level and stability of government finances are undermined. The implications for the poor are potentially disturbing.

The burden of reducing fiscal budgets has tended to fall on infrastructure investments, arguably the most important area for investment in order to facilitate private investment and encourage economic development. The reductions in social spending (although generally proportionally smaller) have potentially damaging consequences for the poor. In particular, reductions in health and education budgets can have extensive long-term impacts for the poorest.

The high and sometimes dangerous volatility of private capital flows is also exacerbated by official flows. Since they exhibit both volatility and pro-cyclicality, they are currently contributing to, rather than minimising, precisely the instability which capital account liberalisation produces.

## **4 Liberalisation and Industry**

To examine the impact of capital account liberalisation on poverty through structural and performance changes in industry, it is necessary to treat separately the different types of capital flow. Foreign direct investment, as a longer-term flow, is not associated with instability in the same way as short-term bank lending and portfolio flows. The

poverty impact of foreign direct investment is not clear, however.

On the one hand, the potential positive impact of FDI in terms of both real investment, export levels, technological capability-building and human capital accumulation can be significant. On the other hand, however, a number of caveats about

the positive impacts should be highlighted. The competitive effects on a market of entry by a well-backed multinational company can be destructive; if domestic firms are unable to compete, the ultimate market size may shrink, reducing employment. Furthermore, multinationals are more likely to source their inputs from abroad, which both reduces the level of domestic employment generated and weakens the recipient country's trade balance. Finally, affiliates of multinationals tend to be less labour-intensive than domestic firms (especially SMEs) and this will have employment (and household income) effects.

In this section we therefore focus on two more directly poverty-related channels. First, the differential impact of short-term capital flow instability on different sizes of firm is considered, together with an analysis of what this means for employment. Second, this section examines the differential impact of changes in credit allocation and the availability of financial services more generally for the poor.

#### **4.1 Liberalisation, Macroeconomic Uncertainty and Financing Investment in Firms**

Short-term capital inflows, and the resultant macroeconomic instability, have a number of important consequences for domestic industry. What is particularly significant here is the asymmetric impact of increased levels of macroeconomic uncertainty on firms and particularly their investment decisions.<sup>26</sup> Smaller firms are disproportionately negatively affected by the potential for volatility associated with capital account liberalisation in developing countries. As was seen in section 2, the channel of credit to and from the domestic financial sector can very quickly dry up, and this danger is especially strong for smaller firms, even when there is not a threat of crisis. This is problematic because small and medium-sized enterprises (SMEs) and very small enterprises (VSEs) account for the bulk of employment in developing economies, because there are fewer larger firms and smaller firms tend to be more labour-intensive.<sup>27</sup>

Uncertainty impacts most strongly on the investments of smaller firms by causing them to

be more volatile and hence less likely to be successful.<sup>28</sup> This leads to their high failure rates (typically 50% after 5 years) and lower growth rates, observed in both developed and developing countries, with concomitant reductions in the employment capacity of the economy and negative impacts on poverty.

#### **4.2 Liberalisation and Credit Availability**

The general air of greater uncertainty that capital account liberalisation causes, and therefore the uncertainty about investment decisions is reinforced by the greater uncertainty about credit availability that SMEs are subject to as a result of both domestic financial liberalisation and capital account liberalisation. The expectations of SMEs concerning their ability to access funds will be a crucial determinant of both their investments and performance, and hence of their employment capacity.

Financial sector deregulation, which involves changes in the freedom both of domestic banks to undertake international transactions and of foreign banks to enter the domestic market, as well as increasing competition, has important ramifications for the availability and allocation of credit.

The classic Stiglitz & Weiss (1981) model of credit rationing shows how banks will refuse credit to firms for viable projects on the basis that obtaining the necessary information on the firms and their investment projects would be too expensive.<sup>29</sup>

This problem is exacerbated in many developing countries by the especially weak position of SMEs. Affiliates of foreign multinationals by their very nature are largely exempt from local financing constraints. Large domestic companies or groups generally have preferential access to bank credit, and are thus relatively protected from capital market fluctuations. SMEs are the most vulnerable then to capital outflow-induced shifts in credit availability, and the concomitant impact on the poor can be strongly negative.

In terms of domestic financial liberalisation, granting domestic banks the freedom to allocate credit on a pure profit basis can have a number of effects. That predicted by theory is the most posi-



tive: simply that banks now compete freely, and hence become more efficient in their credit allocation, make fewer bad loans, support more profitable projects, generate more profits to reallocate and thus facilitate both more and better investments. Gregorio & Guidotti (1992) find for a set of 98 developed and developing countries that about three-quarters of the positive effects of financial sector development result from this type of effect and hence superior quality of investments, and only the remaining quarter from greater quantity of investment.

However, it is important to question the extent to which any increase in lending accrues to the private sector rather than government. Brownbridge & Gayi (1999) survey the changes resulting from financial reforms in eight LDCs: Bangladesh, Laos, Nepal, Madagascar, Malawi, Tanzania, Uganda and Zambia. They find that only Nepal showed a significant rise in private sector bank borrowing. In other words, the observed increase in financial activity may only relate to government operations, and not involve any greater (employment-enhancing) investment by firms.

For SMEs, it is possible that the effect of domestic financial liberalisation is simply to shift the origin of SME financing from the informal to the formal sector, and hence there will be no net benefit in terms of investment volume. Kariuki (1995) confirms this for Kenya's domestic financial liberalisation. For a sample of firms, the average volume of credit fell in every year from 1985 to 1990, except for a 1.5% rise in 1986.

The allocative effects in terms of sector and firm size are also unclear. Jaramillo et al. (1992) conclude that, in the case of Ecuador, financial liberalisation led to more technologically efficient firms receiving a greater share of credit. However, these happen to have been also the largest firms, and it was the previously subsidised smaller firms which suffered a credit withdrawal. As with China today, the impact of liberalisation was to increase credit-rationing among SMEs (see box). For governments, the question will be whether the positive growth effects of greater credit allocation to more efficient larger firms outweighs any employment costs of reduced credit to SMEs.

A second area of financial sector deregulation is the granting of domestic entry to foreign banks and financial institutions. This would be expected to

have similar effects in terms of increased competition and efficiency. Foreign entrants will bring new technologies, new techniques and expertise in risk assessment, which will (at least eventually) filter through to domestic rivals. This should then improve the quality of loans made, and reduce the extent of credit rationing since banks will be better able to assess their limited information on firms. A number of dangers are also present however.

In addition to heightening the risk of crises as discussed in section 2, it is possible that the entrance of foreign banks will have a range of negative impacts on the financial sector. Competition can lead to a number of responses, all of which either reduce costs or increase revenues. In the first category are measures to reduce the cost of obtaining deposits to loan, of running a branch network, of non-performing loans, and of risk assessment.

Reducing the costs of a branch network may have negative consequences for rural dwellers especially. Since rural branches serve a less densely populated area, they may be the obvious choices for closure. Since rural areas are already relatively underbanked (in terms of geographic concentration, though not necessarily by population), this will further limit the access of a significant section of the population to financial services. This has potential costs through reduced saving and investment in rural communities, and hence of reduced output and employment (or subsistence) levels.

Matin, Hulme & Rutherford (1999) point to the success of the Bank Rakyat Indonesia in setting up sub-branch units to reach a mass rural clientele and hence broadening significantly the provision of financial services to the poorest, but this is not a common phenomenon in the wake of financial deregulation. Brownbridge & Gayi (1999) found that entrance into the banking sectors of their eight countries did tend to lead to increased access to financial services - but only in urban areas. Only the purchase of a rival's rural branch network by Finance Bank (Zambia) went against this trend.

Reducing the costs of both non-performing loans and risk assessment are potentially contradictory. If banks choose to reduce the number of poor quality loans, this will involve taking greater care with future lending decisions. Investing in improved risk assessment methods and informa-

tion about potential borrowers should reduce rationing and improve the access to credit of sound businesses (especially the disproportionately rationed SMEs). The easier option however may be to introduce more rationing for smaller firms, and focusing on less informationally opaque larger firms – as seen in China (see box) and probably Kariuki's (1995) Kenyan firms.

Reducing the costs of risk assessment can also involve disintermediation – transferring deposits to (possibly international) capital markets where information is readily available and risks fairly clearly seen, rather than lending them out to businesses. This has obvious negative effects for the

quality of industry investment and resulting employment and poverty levels, although the risk of financial crisis may be lessened.

The alternative response to increased competition involves increasing revenues. This will essentially take the form of raising interest rates on lending, but this may be through redirecting lending to higher risk groups or alternatively to (possibly international) capital markets where returns may be higher. The first of these will have the obvious dangers of raising the risk in the bank's portfolio, and without proper supervision can precipitate crisis. The second will reduce the volume of lending available directly to businesses, and hence

### **Financial Markets in China – Pro-Poor Policy versus Liberalisation**

China's slow but steady progress towards financial and at least partial capital account liberalisation has been characterised by a problem particular to transition economies. On the one hand, the large state-owned enterprises (SOEs) are being privatised, and large numbers of jobs are being cut. The government, despite some ideological misgivings, is desperate to encourage small, private enterprises as the only alternative source of employment (and indeed growth). It is therefore keen to ensure flows of funds for investment to this particular sector, and hence is interested in secondary board (stock) markets to allow smaller firms to raise investment funds, although these remain underdeveloped with problems of transparency and regulatory strength.

On the other hand, the financial liberalisation which is continuing apace is having rather contrary consequences. Part of the World Trade Organisation agreement in place requires that foreign banks' access to domestic markets be greatly increased within a fairly short timeframe. Domestic banks are therefore being hurriedly prepared for the harshest market conditions they have ever faced. While seeking the necessary profitability, and clearing their books of bad loans, they are also trying to find profitable lending opportunities without repeating the same bad loan problems. Moreover, they are being urged to make funds available to the newly approved private enterprises that have little in the way of credit histories or track records of business success by which to signal their creditworthiness.

The result of these competing pressures is that banks are building up large quantities of unlent deposits, since the privatised SOEs are no longer demanding loans in the same quantities, and are not policy-designated lending targets. At the same time, the banks are attempting to introduce market-based risk assessment techniques to prevent bad lending, and hence SMEs are being very strictly rationed. The effects of the ongoing financial and capital account liberalisation then are being seen as a squeeze on lending to already underfunded SMEs, with the inevitable knock-on impacts of reduced investment, growth and employment.

Smaller developing countries, although their banks may not have bad loans to the same extent, are likely to suffer the same effects in terms of greater rationing. Policymakers then are faced with the quandary of liberalising their financial markets and abdicating influence on the targeting of funds, while at the same time seeing the main employment providers of their economies suffering a credit withdrawal. The resultant poverty impacts may be large, even if the ultimate growth effects (of eventually more efficient financial markets) are beneficial.

increase the extent of rationing for smaller firms which cannot access capital markets themselves.

A third aspect of financial sector deregulation, that of freeing-up domestic banks to transact internationally, has been touched on already. The potential for domestic savings to be channeled abroad to international capital markets will lower the availability of credit to domestic firms, although the entrance of foreign banks may compensate for this. The risk is that domestic financial institutions, that do not have sufficient expertise or supervision, will seek funds from foreign financiers without taking into account the exchange risk or the possibility of short-term loans not being rolled over. This was the case in some of the crisis-hit East Asian economies.

Finally, we need to consider in more detail the effects of financial liberalisation and increased competition on rural access to credit. A key feature of especially African developing countries has been the overwhelming absence of deposit-taking institutions willing to handle small sums operating in rural areas. Mosley (2000) notes that this continued unabated after a series of financial liberalisation reforms in Kenya (1982-4), Malawi (1985-7 and 1994-6), Uganda (1992-4) and Lesotho (1994-6). Mosley found that liberalisation brought few direct benefits, but the innovation of (especially Non Governmental Organisation) credit institutions increased access (to some financial services at least) dramatically in both Kenya and Uganda where the NGOs were most active. More worryingly, even in these cases, the access of the very poorest groups did not significantly increase despite the improvement for more marginal individuals below but closer to the poverty line.

Increased competition has not had any noticeable impact on the microfinance institutions. That is, despite the success of, for example, the PCEA Chogoria in Kenya and the CCEI/Gatsby Trust scheme in Cameroon, private sector competitors have not moved in. Furthermore, liberalisation specifically of the microfinance sector has had serious negative effects. In Malawi, the privatisation of the (failing) SACA and Malawi Mudzi Fund led the new company to seek collateral for its credit provision, and hence de facto disqualify a large sector of the poor from access. Mosley makes the more general points that while this type of liberalisation may have negative effects for

poverty, both conventional liberalisation of the interest rate (allowing lending at an interest rate of around 40%, as is common among the microfinance institutions to cover the high costs of networks in rural areas) and policies to promote institutional development can have positive effects.

Matin et al. (1999) survey financial services provision for the poorest in low-income countries and find two trends in particular. One is a general trend towards more low-level, informal financial intermediation (e.g. the return of deposit collectors in Nigeria after a fall in confidence in the banking system); and the other, more situation-specific responses from formal institutions (e.g. the doorstep financial services offered in Dhaka slums by SafeSave).

The overall effects of capital account liberalisation on domestic industry and credit access are far from clear. The apparent absence of research on the preconditions for capital account liberalisation to improve (or at least leave unchanged) the access of domestic firms to credit is indeed paralleled by the absence of research to indicate the preconditions for capital account liberalisation to be at least poverty-neutral. A deeper understanding of the channels involved is required then, even for purely domestic financial liberalisation.

### **4.3 Stock Market Development**

An alternative source of financing for enterprises is through equity, that is, raising money on stockmarkets by selling stock or shares. There is a considerable literature on possible connections between stock market development, and in particular capital account liberalisation in this area, and investment and growth of developing countries.<sup>30</sup> However, the only confirmed benefit is a one-off increase in investment (Henry, 2000), but no long-run increase in the capital stock (Levine & Zervos, 1998). Moreover, since equity markets are dominated by large firms and privatised state firms, the benefits of equity markets will not be directly felt by smaller firms and so the employment impacts will be less. Only in the largest developing countries such as China (see box) have secondary boards – stock markets aimed at allowing smaller firms to raise funds for investment – been at all successful.

As with access to credit, small firms struggle to attract finance through the market because of their informational opacity. This could lend support to the case against focusing efforts too narrowly on stock market development in smaller low-income countries. Additionally, the development of stock markets as opposed to other financial development may act as an incentive for disintermediation. This is the trend for banks to devote greater proportions of their resources to

capital market investment rather than business lending. This has negative implications for poverty where the latter would be more directly productive in terms of employment benefits. While some studies have implied a correlation between stock market development and overall ease of financing, as Demirguc-Kunt & Maksimovic (1999) report, they find no correlation between stock market activity and the ability of smaller firms to access finance.

## **Conclusions**

This paper has reached a number of conclusions concerning the linkages between capital account liberalisation and poverty. While theory implies there will be efficiency benefits for international finance, the existence of growth benefits for developing countries - of both short term flows and FDI - has simply not been established. Moreover, a variety of costs for liberalising countries, and a number of further potential risks, have been identified.

The key conclusion for policy-makers then must be that retention of the option to make use of capital controls within an appropriate macroeconomic policy structure is essential. The underlying assumption that liberalisation has definite benefits is not a sensible starting place from which to begin

policy analysis, whether within the Poverty Reduction Strategy process or more generally.

That discussions on the reform of the global financial architecture must include developing country representatives and viewpoints is also clear. Moreover, the prioritisation of individual codes and standards for individual countries should be based on research of their specific levels of financial and economic development, and not imposed externally on the basis of an unsuitable industrialised country model. Finally, future research work should focus on clarifying the impact of liberalisation on investment on the one hand, and policy restrictions on the other.

## Endnotes

- 1 This is an edited version of a longer paper commissioned by Bretton Woods Project and Oxfam for the *Capital Account Liberalisation and Poverty* meeting held at Queen Elizabeth House, Oxford University on 12th January 2001. A full version of the paper is available at <http://www2.qeh.ox.ac.uk/research/wp.html>.
- 2 Financial Liberalisation refers to both domestic financial liberalisation and capital account liberalisation.
- 3 See the work of McKinnon and Shaw. Following the Mexican crisis of 1982, a view emerged among policymakers that it was closed financial markets that not only caused crises but also failures of economic development. See Rodrik (1996) for more on this issue.
- 4 While some smaller economies (e.g. Honduras) followed a fairly smooth movement towards liberalisation, many of the larger economies (e.g. Chile, Brazil) underwent changes of direction, before returning to liberalisation policies. Morley (2000) and Morley, Machado & Pettinato (1999) detail the position of individual countries.
- 5 Nsouli & Rached, 1998, p1
- 6 See relevant studies by Bayoumi (1993), Chapple (1991), Uygur (1993), and Williamson and Mahar (1998).
- 7 See Beck and Levine (2000), Demirguc-Kunt and Levine (1999), Beck, Demirguc-Kunt, Levine, and Maksimovic (2000).
- 8 Although Beck & Levine (2000) does include, for the first time, some theory of industrial growth to underlie the proposed relationship, following Rajan and Zingales (1999).
- 9 Greenwood & Jovanovic (1989) present the classic model of efficiency gains.
- 10 See FitzGerald & Cobham, (2000) for further details.
- 11 Evidence has been found for a temporary increase in investment caused by stock market liberalisation, that is, a one-off boom (Henry, 2000), although problems of causality remain.
- 12 See for example Demirguc-Kunt & Detragiache (1998) and Williamson & Mahar (1998).
- 13 The analysis in this section will focus primarily on the events in East Asia from 1997, for which data is relatively plentiful. This is not to assume that crises in other (e.g. low income) countries shared exactly the same characteristics, nor to deny their importance.
- 14 As Kamal Malhotra points out in his comments, the costs were even more clear in the MIC cases where the countries were not eligible for IDA concessional financing.
- 15 Lee & Rhee (1999)
- 16 The following paragraphs draw on World Bank (2000).
- 17 This problem has been especially marked in African recipient countries, and with regard to the multilateral donors. See Pallage & Robe (2000) for details.
- 18 I am grateful to discussants at the QEH meeting for highlighting this point. See the comments by Allen and Malhotra in particular for more details. Carvalho (2001) goes further by drawing a parallel between Fund and Bank conditionality and the discipline imposed by capital account liberalisation. He sees both within a process undermining the policy freedom of developing country governments.
- 19 Note that a similar calculation for sterilising net inflows to all developing countries would imply a cost of \$9.6bn in 1998 (or a staggering \$32bn in 1996). However, the question of how capital account liberalisation affects interest rates has not been fully answered. Williamson & Mahar (1998) find that *financial* liberalisation was followed by higher real interest rates in Australia, Bangladesh, Chile, Malaysia, New Zealand, Sri Lanka, Taiwan, Thailand, Turkey and the US, but lower rates in a number of others including Israel, Italy and the UK. A corresponding survey for *capital account* liberalisation does not exist (to the author's knowledge). On the whole, however, capital account liberalisation should provide momentum to a process of equalisation of *risk-adjusted* rates. Since developing country governments' debts are relatively risky, this implies that they are likely to have to pay a higher real (non-risk-adjusted) interest rate on their liabilities (bonds issued) than they receive on their reserve assets (T-bills purchased), although not necessarily by as much as the 15% Stiglitz uses.
- 20 Collier & Gunning (1999) refer to two particular pieces of work reflecting the underlying flaws: "...Haque et al. (1998) show that while the three major investor risk ratings are largely explicable in terms of policy fundamentals, they have a high degree of persistence and the dummy for Africa is large and significant. Hence, newly reformed countries in Africa find that their ratings are slow to change, and that they are contaminated by a 'bad neighbourhood' effect. Jaspersen et al. (1998) show that the risk ratings are significant in regressions of private investment" (pp.11-12).
- 21 See FitzGerald & Cobham (2000) for a comprehensive survey.
- 22 I am grateful to discussants at the QEH meeting for clarifying this. See the comments of Adam and Kasekende in particular.
- 23 Note that this effect of potential capital flight is compounded by a different effect of *actual* outflows. Outflows will erode the tax base (by reducing the total stock of capital and labour in the economy). Even if the tax structure is unchanged by capital flight, proportionally more tax will fall on the remaining capital and labour. Since the percentage of transferable (capital) assets of a person will be lower, the poorer he or she is, the poor are least able to avail themselves of the potential for capital flight and suffer most from the changed balance of taxation.
- 24 See, e.g., UNCTAD, 1999: "There was consensus [among the experts assembled by UNCTAD] that while [tax] incentives have their pros and cons, their role essentially remains subsidiary. More fundamental factors are political and economic stability, project feasibility, market considerations, investment climate and infrastructure" (p.9).
- 25 Haufler & Wooton (1999)
- 26 UNCTAD's Trade & Development Report (1996) shows that even advanced countries have seen basic macroeconomic variables - i.e. consumption, investment, trade - become more volatile since financial liberalisation.
- 27 Mead & Leidholm (1998) survey the available data and show that the share of microenterprises or Very Small Enterprises (VSEs) in employment (of those aged 15-64) runs from 17% to 27%:

Botswana 17%, Kenya 18%, Lesotho 17%, Malawi 23%, Swaziland 26%, Zimbabwe 27% and the Dominican Republic 19%. With the exception of the latter, the employment in question is predominantly in rural, non-town areas, and in commerce rather than manufacturing. The majority of VSEs are owned by females and employ a majority of female workers.

- 28 The general effects of uncertainty about macroeconomic and market-specific prospects on investment have been analysed extensively through the literature on the 'real options' approach (see Dixit & Pindyck, 1994). Essentially, the models show how invest-

ment can be either increased or reduced by the level of uncertainty faced by firms in a market.

- 29 Combining this with investment under uncertainty shows how smaller firms are constrained to make relatively bad decisions - decisions which are more time-constrained, and inevitably result in more volatile outcomes. This causes in particular the high death rates of SMEs.

- 30 See Durham (2000)

## References

- Adam, C. (1999), 'Liberalisation, Policy Reform and the Demand for Money in Africa,' *Journal of African Economies* 8, 263-7.
- Bayoumi, T. (1993), 'Financial Deregulation and Consumption in the United Kingdom,' *Review of Economics and Statistics* 75, 536-9.
- Beck, T. & R. Levine (2000), 'New Firm Formation and Economic Growth,' *World Bank Working Paper Series* 2383.
- Beck, T., A. Demirguc-Kunt, R. Levine & V. Maksimovic (2000), 'Financial Structure and Economic Development: Firm, Industry and Country Evidence,' *World Bank Working Paper Series* 2423.
- Biggs, M. (1998), 'Deficits and Economic Growth: Lessons from Developing Countries,' in I. Abedian & M. Biggs (eds.), *Economic Globalization and Fiscal Policy*, Oxford: Oxford University Press.
- Brownbridge, M. & S. Gayi (1999), 'Progress, Constraints and Limitations of Financial Sector Reforms in the Least Developed Countries,' *IDPM Finance and Development Research Programme Working Paper Series* 7.
- Buch, C. & R. Heinrich (1999), 'Handling Banking Crises — The Case of Russia,' *Kiel Institute of World Economics Working Paper Series*.
- Carvalho, F. (2001), 'Political Democracy and Unfulfilled Aspirations: Has Democracy Let People Down in Latin America?', mimeo. Forthcoming in *Configuraciones*, Revista de la Fundacion Carlos Pereyra, Mexico.
- Chapple, S. (1991), 'Financial Liberalization in New Zealand, 1984-90,' *UNCTAD Discussion Paper Series* 35.
- Chomthongdi, J. (2000), 'The IMF's Asian Legacy,' mimeo., Focus on the Global South.
- Collier, P. & J. Gunning (1999), 'The IMF's role in structural adjustment,' *Centre for the Study of African Economies Working Paper* WPS/99-18.
- Demetriades, P. & M. Devereux (1992), 'Investment and Financial Repression,' Theory and Evidence from 63 LDCs,' *Keele University Economics Working Paper* 92/16.
- Demirguc-Kunt, A. & E. Detragiache (1998), 'Financial Liberalization and Financial Fragility,' in *Proceedings of the Annual Bank Conference in Development Economics*, Washington DC: World Bank.
- Demirguc-Kunt, A. & V. Maksimovic (1999), 'Institutions, Financial Markets and Firm Debt Maturity,' *Journal of Financial Economics* 54, 295-336.
- Demirguc-Kunt, A. & R. Levine (1999), 'Bank-based and Market-based Financial Systems: Cross-country Comparisons,' *World Bank Working Paper Series*.
- Dixit, A. & R. Pindyck (1994), *Investment under Uncertainty*, Princeton: Princeton University Press.
- Doolley, M. & K. Kletzer (1994), 'Capital Flight, External Debt and Domestic Policies,' *NBER Working Paper Series* 4793.
- Durham, B. (2000a), 'A Survey of the Econometric Literature on the Real Effects of International Capital Flows in Lower Income Countries,' *Queen Elizabeth House Working Paper Series* 50.
- Durham, B. (2000b), 'Econometric of the Real Effects of Cross-Border Capital Flows in Emerging Markets,' *Queen Elizabeth House Working Paper Series* 52.
- Durham, B. (2000c), 'Econometrics of the Effects of Stock Market Development on Growth and Private Investment in Lower Income Countries,' *Queen Elizabeth House Working Paper Series* 53.
- Ferri, G. & T. Soo Kang (1999), 'The Credit Channel at Work: Lessons from the Republic of Korea's Financial Crisis,' *World Bank Working Paper Series* 2190.
- FitzGerald, V. (1999), 'Policy Issues in Market Based and Non Market Based Measures to Control the Volatility of Portfolio Investment', *Queen Elizabeth House Working Paper Series* 26.
- FitzGerald, V. & A. Cobham (2000), 'Capital Flight: Causes, Effects, Magnitude And Implications For Development,' *Background Paper for Department for International Development (UK)'s White Paper on Globalisation*.

- Fry, M. (1978), 'Money and Capital or Financial Deepening in Economic Development?', *Journal of Money, Credit & Banking* 10, 464-75.
- Fry, M. (1980), 'Saving, Investment and Growth, and the Cost of Financial Repression,' *World Development* 8, 317-27.
- Fry, M. (1984), 'Saving, Financial Intermediation and Economic Growth in Asia,' *Asian Development Review* 2, 82-91.
- Fry, M. (1989), 'Financial Development: Theories and Recent Experience,' *Oxford Review of Economic Policy* 5, 13-28.
- Fry, M. (1995), *Money, Interest and Banking in Economic Development* (2<sup>nd</sup> ed.), London: John Hopkins.
- Glick, R. & M. Hutchinson (1999), 'Banking and Currency Crises; How Common are Twins?', *Federal Reserve Bank of San Francisco, Pacific Basin Working Paper Series*, 99-07.
- Greenwood, J. & B. Jovanovic (1989), 'Financial Development, Growth, and the Distribution of Income,' *NBER Working Paper* 3189.
- De Gregorio, J. & P. Guidotti (1992), 'Financial Development and Economic Growth,' *IMF Working Paper* WP/92/101-EA.
- Haque, N.U., M. Nelson and D.T. Mathieson (1998), 'Creditworthiness Ratings: Their Political and Economic Content,' in P. Collier and C. Pattillo (eds.), *Investment and Risk in Africa*, London: Palgrave.
- Haufler, A. & I. Wooton (1999), 'Country size and tax competition for foreign direct investment,' *Journal of Public Economics* 71, 121-139.
- Henry, P. (2000), 'Do Stock Market Liberalizations cause Investment Booms?', *Journal of Financial Economics* 58, 301-34.
- Honohan, P. & D. Klingebiel (2000), 'Controlling the Fiscal Costs of Banking Crises,' *World Bank Working Paper Series* 2441.
- Hussain, M. (1996), 'Financial Liberalization, Currency Substitution and Investment: The Case of Egypt,' *African Development Bank Research Paper* 24.
- IMF (1999), *World Economic Outlook (May)*, Washington DC: International Monetary Fund.
- Jaramillo, F., F. Schiantarelli & A. Weiss (1992), 'The Effect of Financial Liberalization on the Allocation of Credit: Evidence from a Panel of Ecuadorian Firms,' *World Bank Working Paper* 1092.
- Jaspersen, F.Z., A.H. Aylward and A.D. Kox (1998), 'The Effects of Risk on Private Investment: Africa Compared with other Developing Areas,' in P. Collier and C. Pattillo (eds.), *Investment and Risk in Africa*, London: Palgrave.
- Jung, W. (1986), 'Financial Development and Economic Growth: International Evidence,' *Economic Development and Cultural Change* 34, 333-46.
- Kariuki, N. (1995), 'The Effects of Liberalisation on Access to Bank Credit in Kenya,' *Small Enterprise Development* 6, 15-23.
- Khan, M. & N. Huq (1990), 'Adjustment with Growth: Relating the Analytical Approaches of the IMF and World Bank,' *Journal of Development Economics* 32, 155-79.
- King, R. & R. Levine (1993), 'Finance and growth - Schumpeter might be right,' *Quarterly Journal of Economics* 108, 717-737.
- Klein, M. & G. Olivei (1999), 'Capital account liberalization, financial depth and economic growth,' *NBER Working Paper* 7384.
- Kraay, A. (1998), 'In Search of the Macroeconomic Benefits of Capital Account Liberalization,' *mimeo.* (preliminary draft), World Bank.
- Lee, J.-W. & C. Rhee (1999), 'Social Impacts of the Asian Crisis: Policy Challenges and Lessons,' *UNDP HDRO Occasional Paper* 33.
- Levine, R. & S. Zervos (1998), 'Stock Markets, Banks and Economic Growth,' *American Economic Review* 88, 537-58.
- Matin, I., D. Hulme & S. Rutherford (1999), 'Financial services for the poor and poorest: deepening understanding to improve provision,' *IDPM Finance And Development Research Programme Working Paper Series*.
- McKinnon, R. (1973), *Money and Capital in Economic Development*, Washington DC: Brookings Institution.
- Mead, D. & C. Liedholm (1998), 'The dynamics of micro and small enterprises in developing countries,' *World Development* 26, 61-74.



- Morley, S.(2000), 'The impact of reforms on equity in Latin America,' background paper for *WDR 2000*.
- Mosley, P. (1999), 'Micro-Macro Linkages in Financial Markets: The Impact of Financial Liberalisation on Access to Rural Credit in Four African Countries,' *Journal of International Development* 11,367-84.
- Nsouli, S.& M.Rached (1998), 'Capital Account Liberalization in the Southern Mediterranean Region,' *IMF Paper on Policy Analysis and Assessment* PPAA/98/11.
- Pallage, S.& K.Robe (2000), paper presented at *Computing in Economics and Finance 2000* conference, UPF-Barcelona, 8<sup>th</sup> July 2000.
- Quinn, D. (1997), 'The correlates of change in international financial regulation,' *American Political Science Review* 91,531-552.
- Rajan, R.G. & L.Zingales, 1999, 'Financial Systems, Industrial Structure and Growth,' paper prepared for the *Symposium on the international Competitiveness of the Swedish Financial Industry*, available on: <http://gsbwww.uchicago.edu/fac/raghuram.rajana/research/finsys.pdf>
- Rodrik, D. (1996), 'Understanding Economic Policy Reform,' *Journal of Economic Literature* 34.
- Schineller, L.(1997). "An Econometric Model of Capital Flight from Developing Countries," International Finance Discussion Paper, No. 579.(Washington, D.C.:Board of Governors of the Federal Reserve System).
- Schmidt-Hebbel, K., L.Serven & A.Solimano (1994), 'Saving, Investment and Growth in Developing Countries: An Overview,' *World Bank Policy Research Working Paper* 1382.
- Shaw, E.(1973), *Financial Deepening in Economic Development*, New York:OUP.
- Singh, A. & A.Zammit (2000), 'International capital flows: identifying the gender dimension,' *World Development* 28,1249-1268.
- Stiglitz, J. & A.Weiss (1981), 'Credit Rationing in Markets with Imperfect Information,' *American Economic Review* 71,393-410.
- Stiglitz, J. (2000), 'Capital market liberalization, economic growth, and instability,' *World Development* 28,1075-1086.
- Toye, J. (2000), 'Fiscal crisis and fiscal reform in developing countries,' *Cambridge Journal of Economics* 24,21-44.
- Uygun, E.(1993), 'Liberalization and Economic Performance in Turkey,' *UNCTAD Discussion Paper Series* 65.
- UNCTAD (1996), *Trade and Development Report*, Geneva:United Nations Conference on Trade and Development.
- United Nations Conference on Trade and Development (1999), 'Report Of The Ad Hoc Expert Group Meeting On Efficiency And Cost Benefit Assessment Of Host Country Tax Incentives And Technical Assistance Needs,' Geneva:UNCTAD.
- United Nations Conference on Trade and Development (2000), 'World Investment Report, 2000: Cross-border Mergers and Acquisitions and Development,' Geneva:UNCTAD.
- Williamson, J. & M.Mahar (1998), 'A Survey of Financial Liberalization,' *Essays in International Finance* 211.
- World Bank (2000), *World Development Report 2000: Challenging Poverty*. Washington, DC: World Bank.