Dr Louis A. Kasekende
Deputy Governor, Bank of Uganda

Uganda liberalised its capital account in July 1997, following a long financial liberalisation process that started in 1992 with liberalisation of the credit and exchange markets and included the opening of the current account. My critique is, therefore, based on my experience as practitioner in a central bank operating under a fully open economy.

The paper makes a striking conclusion,arguing that capital inflows that occur in the wake of liberalisation of capital accounts do not bring specific benefits to an economy.The findings show that these flows cause massive and clear costs to the poor in terms of reduced social expenditure, reduced level of transfers, increased unemployment and reduced wages.In other words,the case for capital account liberalisation is weak.

A faulty Conclusion?

I find this conclusion rather startling for the following reasons. First and foremost, capital account liberalisation does not necessarily lead to capital flows. Capital will always flow into areas or economies were they will fetch high returns or are safe. For, example, in most African countries before financial liberalisation,there were distortionary or bad policies, which generated uncertainty that caused capital flight even in the presence of capital flow controls. Conversely, most of these countries experienced return of capital flight after financial liberalisation. Uganda, for example, earns on average, US$500million annually from the return of capital flight and workers' remittances alone since it liberalised its capital account.

The effects of capital flows on an economy depend upon the reason for their entry, and how they are used once they arrive. It is my submission that flows,which allow foreign investors to hedge risks or increase short-term rates of return,are likely to be speculative, temporary and destabilising. Nevertheless, if the correct policy responses are chosen, that can be dealt with.These flows are likely to be portfolio investments or financial derivatives. Likewise, flows that respond to changes in productivity and potential output (i.e., the supply potential and demand conditions) are likely to be permanent and beneficial to the economy.

In general, capital inflows that are associated with an increasing share of investment in GDP are, over the longer term,likely to be more beneficial to the economy. If the share is dominated by domestic consumption,little benefit will accrue to the domestic economy unless it spurs a supply and productivity response, for example, when an economy is in recession.

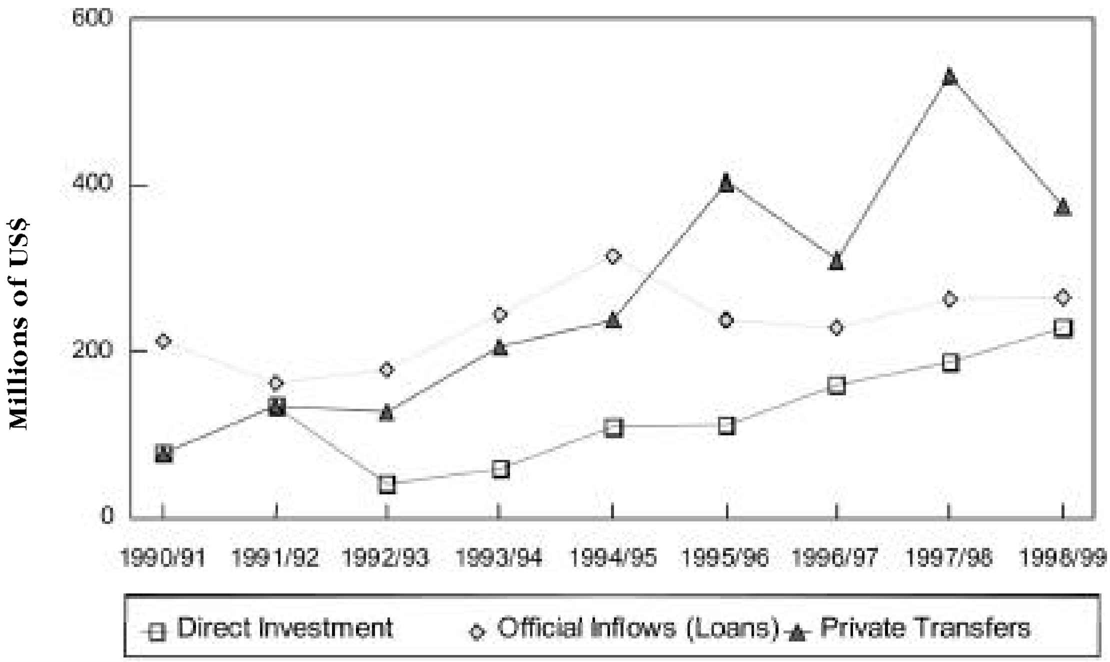
Another aspect, is whether or not the inflows are debt creating, and if so, is the current deficit they generate sustainable? My judgement is that non-debt-creating inflows are beneficial to any economy. Uganda attracts such flows in the form of workers remittances and FDI. If however, the flows are debt creating,the economy will still benefit so long as the current deficit they generate is sustainable.That is to say, any increase in foreign liabilities caused by capital inflows would eventually have to be repaid through higher exports.

Uganda's Experience

In Uganda,the liberalisation of the capital account has been followed by relatively large trade flows, transfers and investment flows. Returning capital flight constitutes the bulk of these inflows,but foreign direct investment (FDI) has also increased. Uganda has,therefore,not suffered from volatility of inflows associated with portfolio investment-type flows. A recent pilot survey by Bank of Uganda confirms that portfolio investment does not exist in Uganda, but that cross-border debt may exist.

Chart 1 shows developments in FDI and other inflows from 1990/91 to 1998/99.FDI inflows rose from US$2 million recorded in 1991/92 to US$230 million in 1998/99. Similarly, private transfers increased from US $ 80.5 million in 1990/91 to US $ 415.2 million in 1995/96 but suffered a drop in 1996/97 to US $ 308.3 million.In the subsequent year, private transfers recovered to a record level

Chart 1: Capital growth in Uganda 1990/91 to 1998/99



of US $ 539.0 million.Unfortunately, the recovery was short-lived and private transfers fell back to US$375.0 million in 1998/99.

Given Uganda's low domestic savings ratios, liberalisation of the capital account and the associated flows has boosted Uganda's investment performance.Table 1 shows that private sector investment rose from 12.6 per cent of GDP in FY 1996/97 to 12.8 per cent in FY 1998/99 and is projected to rise to 17.0 per cent in FY 2002/3.

The sum total of all this is that Uganda has been growing at an annual average rate of 6.5%. The fastest growth areas have been manufacturing,construction,and the transport and communication sectors.The Household Survey conducted, recently, indicates that poverty has been reduced from 56% to 46% in absolute terms. This is evidence that there are growth benefits of capital account liberalisation.

Table 1: GDP Growth, Private Savings and Private Investment (% of GDP)

Period	95/96	96/97	97/98	98/99	99/00	2000/1 proj.	2001/2 proj.	2002/3 proj.
Monetary GDP	75.7	78.3	77.0	77.0	77.0	–	–	–
Non-monetary GDP	24.3	21.7	23.0	23.0	23.0	–	–	–
Gross Domestic Investment	18.4	18.5	16.9	18.8	24.6	17.8	25.1	25.6
Public	–	6.4	5.7	6.0	10.9	8.7	8.6	8.6
Private	–	12.6	11.2	12.8	13.7	9.1	16.4	17.0
Gross National Savings	15.7	17.6	14.7	14.4	19.3	13.3	18.0	19.6
Public	–	4.4	5.2	4.6	2.6	7.1	4.8	5.3
Private	–	13.2	9.4	9.8	16.7	6.2	13.3	14.3
M2/GDP	10.9	11.7	12.3	12.1	11.4	11.8	12.1	12.2
Nominal GDP	5,565.3	6,022.9	7,104.0	7,963.4	8,655.8	9443.0	10568.0	11,858.0
(billions of shillings)	9	5	30	1	8	0	0	0

Source:Background to the budget 2000/1 and Ugandan authorities and Fund Estimates and Projection

Other benefits

Financial repression resulted in negative returns on financial assets, which led to inefficient financial intermediation and low savings.Controls also caused duality in the economy with the emergence of parallel markets in the goods and service market, and in the market for foreign exchange. This tended to constrain development of markets and,consequently proper allocation of resources.

Liberalisation appears to have released the claws of control and reintroduced price signals for allocating resources by restoring confidence in the role of the free market.This is evidenced by the return of capital flight. Financial liberalisation has also brought about increase in farm gate prices,financial deepening,increase in domestic savings,etc.

Risks of capital account liberalisation

As financial liberalisation shifts the risk burden from government to the private sector the risks can complicate macroeconomic management. For example,open capital accounts can offer financial institutions the opportunity to provide open, unfunded letters of credit,guarantees and banking services to both residents and non-residents in both domestic and foreign currencies,and off-balance sheet transactions. These services can be sources of exchange and credit risks especially to the domestic banks,which may have little experience in managing the risks. The risks can make financial institutions become insolvent.

In Uganda, we have noticed that speculators can switch deposits between accounts denominated in local and foreign currencies whenever there are depreciationary or appreciationary pressures in the foreign exchange market. We have also noticed dollarisation of transactions whenever there are severe depreciationary pressures on the shilling.This distorts the distinction between tradeables and non-tradeables in the domestic economy and makes the calculation of real exchange rate difficult. All these complications pose monetary policy challenges to the central bank and constrain financial intermediation. However, the solution is not to re-impose capital controls since,in my view, the benefits of an open economy far outweighs the costs, but to improve the quality and dissemination of data, maintain macroeconomic stability, strengthen supervision of the financial system and improve instruments for hedging against risks.

Response to specific findings of the CAL & Poverty Paper

I now respond quickly to the specific conclusions about the impact of capital account liberalisation on economies as revealed by the survey of research findings.

There is no evidence that financial liberalisation increases the cost of funding. In our case, interest rates have come down significantly from 50% before financial liberalisation to the current average of 21%. There is also growing evidence that some firms are soliciting cheap funds offshore.The problem in Africa is really not of high interest rates, but of availability of bankable projects.This makes banks shy away from lending.

There is no guarantee that high fiscal deficits accommodate pro-poor projects. It may lead to inefficient financing thus, hurting the poor. It could also lead to inflation if government borrowing is from the central bank.

Nevertheless, under a liberalised environment and tight budget management, the poor can still be protected:

- develop markets so that monetary policy can be relied upon to manage short term shocks;
- ring fence social expenditure. Uganda uses Medium Term Expenditure Framework (MTEF) to increase predictability of budgetary policy and budgetary allocations by providing a three-year rolling projections and budget ceilings for each sector. The intention is to provide each sector with the predictable flow of resources;
- maintain macroeconomic stability.

Filomeno S. Sta. Ana III
Action for Economic Reforms, Philippines

The Cobham study on capital account liberalisation and its impact on poverty is indeed refreshing, for it substantially discusses and analyses the costs of capital account liberalisation during the so-called normal times. Until this time, the literature on the social effects of capital account liberalisation during the non-crisis or pre-crisis period is scarce.

It is difficult to establish a direct link between capital account liberalisation and poverty, but the link can be established indirectly through macroeconomic mechanisms such as fiscal policy, monetary policy, and exchange-rate policy. Yet the determination of macroeconomic policies rests on other considerations and objectives.This is not to dismiss the relevance of the link; rather it demonstrates how extraordinary the challenge is to advance the proposition that capital account liberalisation contributes to poverty.

Government Financing

One cost elaborated in the Cobham paper pertains to the constraint on government finances. The proneness of many developing countries to borrow to finance growth makes it tempting for them to liberalise their capital accounts. To be sure, governments should first and foremost rely on national savings,including taxes,before resorting to borrowing. However, the problem of some countries, including the Philippines, is that even when there is economic recovery or growth, tax collection as a proportion of GNP remains dismal. Growth is not only the determinant of tax receipts, other important variables include the efficiency of tax administration, the extent and degree of tax evasion, the confidence in governance,and the quality of growth itself.

Putting in place a comprehensive tax reform agenda that makes the tax system efficient, progressive and buoyant reduces the temptations of governments to liberalise their capital accounts.In the case of high-growth economies wherein national savings together with tax collection are relatively high (e.g., Korea), capital account liberalisation became an attractive substitute to painful domestic reforms as a means to obtain more capital to reach a higher level of economic maturity. Bluntly said, capital account liberalisation has become a lazy way of getting financing.

Capital account liberalisation by itself does not automatically translate into significant capital inflow. Capital-scarce countries must compete for capital coming from abroad. This brings to the fore the issue of locational competition, for which tax policy is an important tool. The implication of this is that it is not labour in general that suffers from the heavier tax burden,as compared to capital,but the part of labour that is the least mobile, i.e. the low skilled, low educated (the poor, in short). Highly mobile labour, which is highly skilled, highly educated, would tend to benefit from the reduction of income tax rates.Because of tax competition, governments in capital-scarce countries are tempted,if not compelled,to reduce income tax rates, which tends to make the tax structure less progressive or more regressive.With the share of revenues sourced from direct taxes (corporate and individual) shrinking (and may we add the reduction of tariffs as well), governments can be expected to rely more and more on indirect taxes and user fees. Undoubtedly, this would impact not only on labour in the formal sector but also on labour in the informal sector, the underemployed,and the unemployed.

Market Discipline

A final point on fiscal policy as it relates to capital account liberalisation is the debatable proposition that,"where governments are using fiscal deficits inefficiently, the market discipline effect of liberalization will be to curtail the wasteful use of limited resources."As the paper points out, this may have "no direct poverty effects." Undeniably "market discipline" is an effective way to curtail inefficient fiscal deficits.The assumption is that a target of a low budget deficit or a balanced budget will force government to spend wisely and efficiently. However, it can be argued that the reduction of government spending, even if such spending was inefficient, will have an impact on poverty reduction. The cut in deficit spending will still reduce the expenditures for social and economic services.

We have to be emphatic in criticising the current tendency to dogmatise the correctness of low budget deficits using a rigid benchmark. The dogma absolutely treats low budget deficits or balanced budgets as part of market discipline and good fundamentals but where on earth is the evidence that a budget deficit breaching three percent of GNP or approximating four percent of GNP is "alarming" (the word used by pundits to describe the current Philippine government deficit of four percent of GNP)?

In the Philippine case, I will be the first to concede that the deficit of the Estrada administration is indeed alarming. It is using the deficit to cover up its failure and lack of political will to reform tax administration and address tax evasion. Massive government resources, which enlarge the deficit, are being used to prop up a morally bankrupt and venal administration. But whilst its important to address this, it has nothing to do with what is an acceptable deficit level.

Exchange Rate and Interest Rates

The pernicious effects of high interest rates and an overvalued currency need further elaboration. Higher interest rates as a result of sterilisation lead to a dampening of investments and a rise in unemployment. Further, higher domestic interest rates attract more capital from abroad, leading to further currency overvaluation. In turn, the strong or overvalued currency undermines the real sector of the economy. Both exports and import substitutes are penalized. The overvalued currency makes exports expensive and imports cheap to the detriment of competing domestic goods. Again, this means displacement of workers both in agriculture and in industry.

Further, the overvalued currency leads to investors shifting from tradables to non-tradables. For a country with a soft state (the Philippines being a prime example), this would all the more reinforce the "booty capitalist" character of the state. Paul Hutchcroft (1998) defines booty capitalism as a patrimonial state typified by business interests capturing the state apparatus. To be sure, the capture of the state's regulatory power becomes a main agenda of vested interests engaged primarily in non-tradables such as utilities, telecommunications, transportation, and real property.

Rethinking Growth Strategy

Finally, the debate on capital account liberalisation is linked to the debate on growth strategy. Undeniably, growth is a necessary condition to eradicate poverty. But the debate revolves around the quality of growth. Capital account liberalisation, it is argued, is necessary for growth. Empirical evidence (and common sense) would show that financial flows merely follow growth. This is the direction of the causality. Among the variables that attract capital from abroad are a) the rate of return on domestic assets being greater than the rate of return on assets of the rest of the world (in this regard, interest rates are a proxy to assets) and b) the risk premium. It is hence unsurprising that the major recipients of capital or financial flows are the high-growth economies, especially in East and Southeast Asia.

Clearly then, it is in normal times or in times of growth when all kinds of capital are pouring into the economy. And it is precisely during these times that an extraordinary measure like capital control is necessary. The liberal flow of capital may inflate growth, but such growth as the 1997 crisis has proven, is risky and unsustainable and has enormous social costs. Given the bitter lessons of the 1997 global financial crisis, will policymakers allow capital exuberance to dominate the economy in the name of growth? Or will they temper the growth by, inter alia, screening capital flows as a means to make growth more sensitive to development goals? It is a relief to know that even the most conservative institutions like the IMF have conceded the relevance and appropriateness of capital controls in certain conditions. Such acknowledgment is enough to move forward the debate towards formulating the policies and measures that will check the dangers attendant to excessive and fickle financial flows.

Aart Kraay
World Bank

Should we expect capital account liberalisation to have large measured growth effects?

Measuring capital controls is difficult:

- almost all measures of policy based on IMF *Exchange Arrangements and Exchange Restrictions* which measures the presence (not strength) of selected (not comprehensive) controls on residents (not foreigners);

- the few available measures of outcomes such as volume of capital flows or onshore-offshore interest differentials are also problematic.

Should capital account liberalisation have direct growth effects?

- Theory points to better risk sharing and better allocation of investment with at most one-time *level* effects on income.

Possible links to growth less clear, one mechanism might be that better risk sharing lets investors choose higher-return but riskier projects?

Should capital account liberalisation have indirect growth effects?

- "CAL leading to investment leading to growth" argument is weak because it assumes that (i) capital controls are the binding constraint,and (ii) investment raises growth, both of which are dubious propositions empirically;

- "CAL leading to policy discipline (i.e. macro-economic stability) to growth" argument is more plausible and there is independent evidence for both steps in the argument. But effects of CAL may not show up in growth regressions that control for other dimensions of policy.

Given these ambiguities it is not surprising that much empirical evidence is messy (but *some* evidence of benefits *does* exist).

On *growth effects* Quinn (1997) finds pretty robust evidence that capital account liberalisation raises growth.

Some evidence that capital *controls* are associated with crises.

Does capital account liberalisation raise inequality?

The paper presents several arguments that capital account liberalisation limits the possibility of pro-poor fiscal policy by:

- worsening the terms on which governments borrow

- diverting public resources to cover the interest costs of sterilizing capital inflows

- "excessive discipline" placed on fiscal policy by fickle and uninformed international investors

- narrowing the tax base through capital flight and exemptions for foreign investors.

Two conditions are necessary for these to lead to greater income inequality:

- in the absence of capital account liberalisation public policy is pro-poor;

- policy adjustment to this discipline is anti-poor.

Since this is an empirical question it is helpful to look at the (very imperfect) data on capital account liberalisation, fiscal outcomes, and inequality (which the paper unfortunately does not do).

- Collect data on capital controls (IMF indicator of restrictions on capital account transactions), fiscal policy outcomes (government consumption/GDP, fiscal deficits/GDP, public spending on health and education/total public spending), and inequality and poverty outcomes (Gini index, average incomes in bottom quintile,and dollar-a-day headcounts).

- Set of observations limited by availability of income distribution and poverty data (forms an unbalanced and irregularly-spaced panel of observations). Restrict attention to inequality observations spaced at least five years apart, collect data on average of policy variables in five years prior to date of survey.

Look at relationship with CAL in *levels* and in *changes*.

Simple (-minded?) correlations are not very promising in terms of delivering clear evidence that capital account liberalisation matters for fiscal policy or is associated with higher inequality and poverty. But of course there are lots of caveats such as:

- presence of capital controls may be proxying for low income (or other things);

- relationship between capital controls and outcomes plausibly different in rich and poor countries.

To begin to address these problems estimate regressions for rich and poor countries like:

$$\text{Outcome} = ß_0 + ß_1 \text{ Income} + ß_2 \text{ Capital Controls} + e$$

$$\Delta\text{Outcome} = ß_1 \text{ DIncome} + ß_2 \, \Delta\text{Capital Controls} + \Delta e$$

Simple (-minded?) regressions are also not very promising in terms of delivering clear evidence capital account liberalisation matters for fiscal policy or is associated with higher inequality and poverty. But of course there are lots of caveats:

- Measurement is difficult, for capital controls (as discussed above) and especially poverty and inequality (where we are constrained by the limited availability of high-quality comparable household survey data). So can't rule out possibility that in all of this the data simply aren't informative *for either the view that capital account liberalisation does matter for policy, poverty and inequality, or that it does not.*

- There may be plenty of non-linearities or omitted variables which are obscured by parsimonious linear regressions like these.

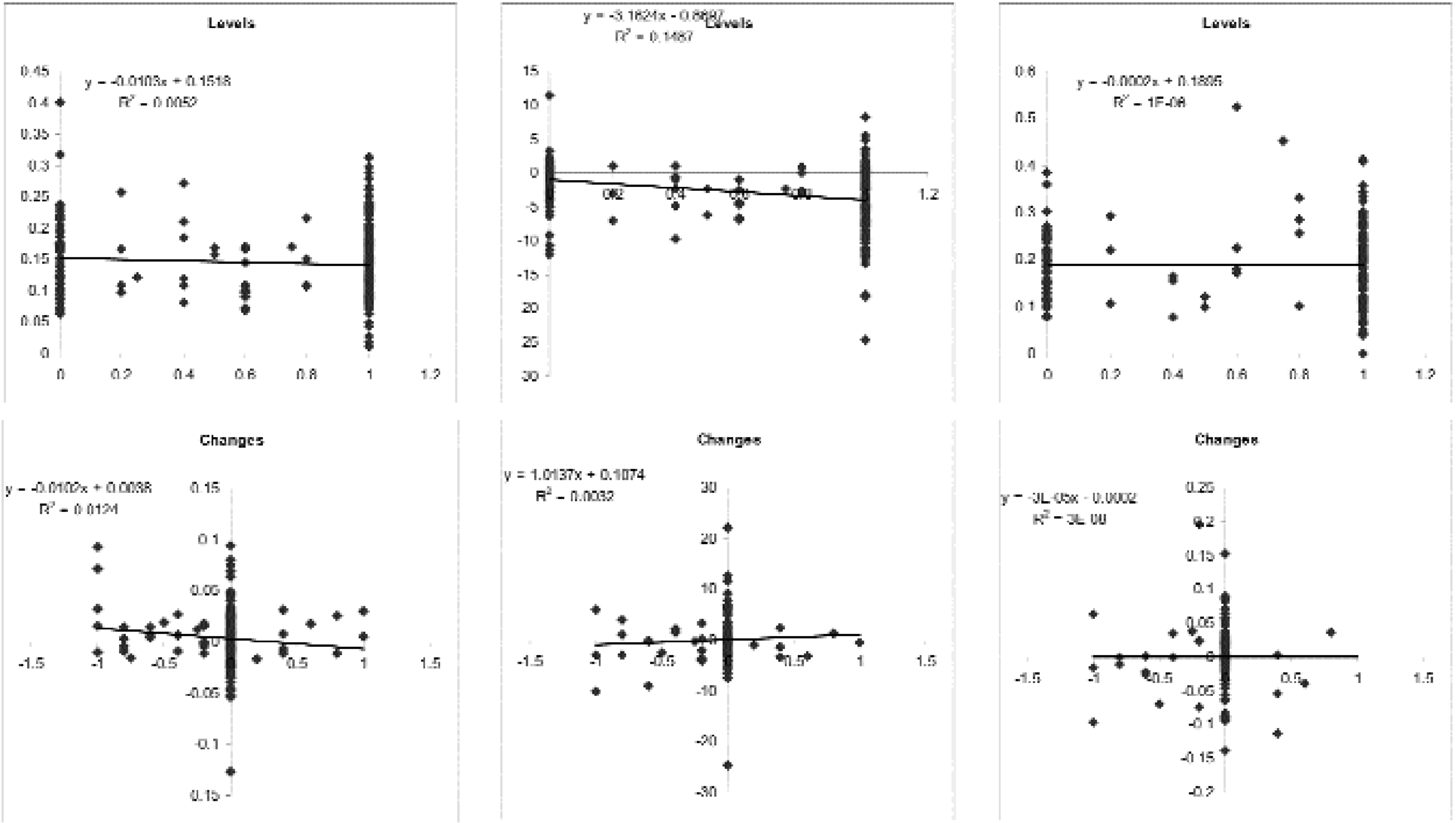
What does all this mean for capital account liberalisation and poverty reduction?

Clearest conclusion that emerges from the empirics is that there are no clear conclusions. And so the "burden of proof" for unravelling the benefits and costs of capital account liberalisation lies with all those interested in providing sound development policy advice.

- Can capital account liberalisation either be advocated or ruled out because of its first-order consequences for poverty? *Probably not.*

- Can capital account liberalisation be a useful component of a broader package of reforms designed to make markets,especially financial markets, work better? *Probably, with all of the usual appropriate caveats about sequencing, supporting institutions, etc.*

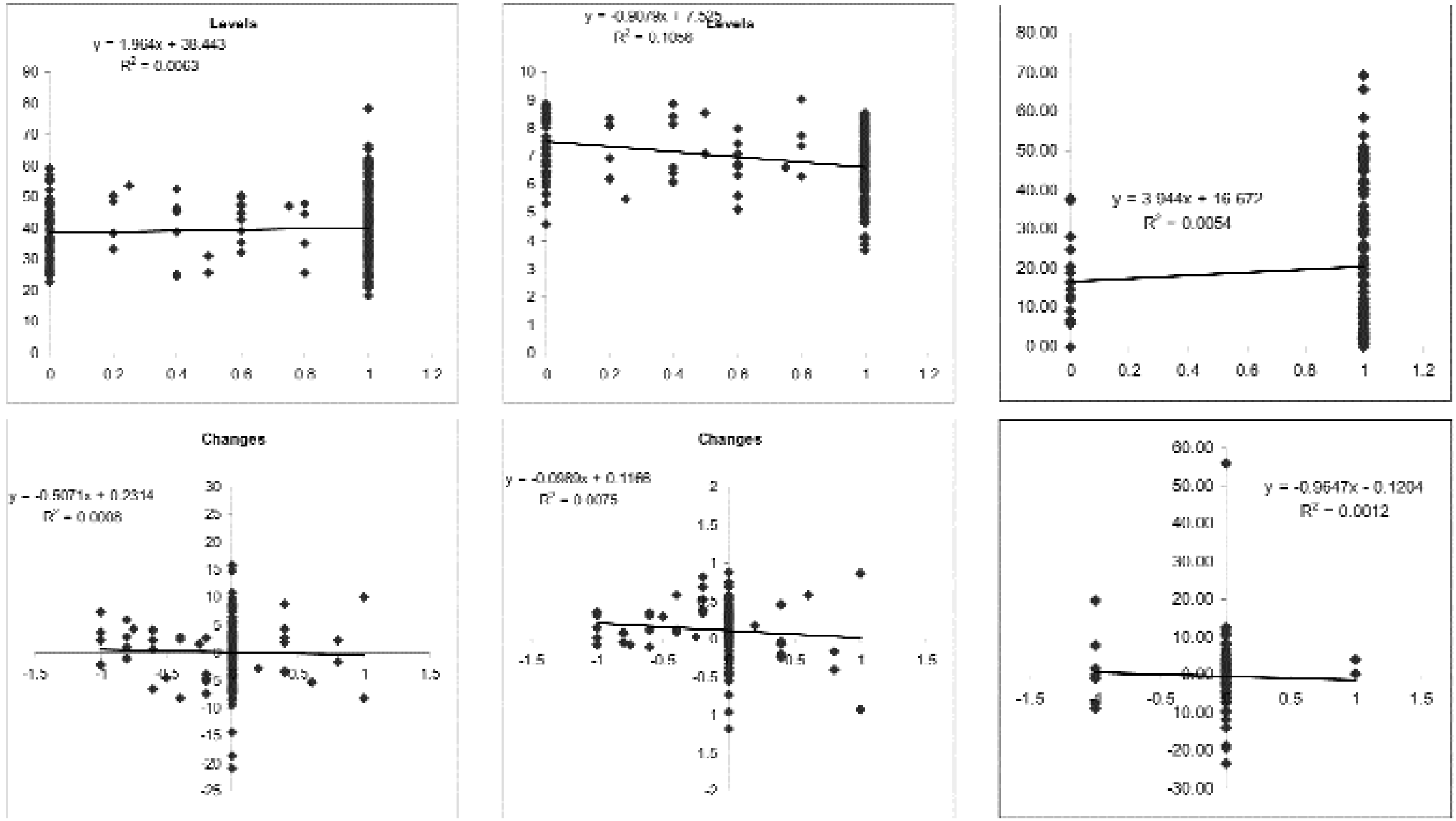
Gov't Cons/GDP | **Fiscal Deficit/GDP** | **Social Spending/Total Spending**



These Graphs show the relationship between the indicated variable (on the vertical Axis) and a five-year average of an IMF index of restricationson capital account transactions, where a zero indicates no restrictions and a 1 indicates restrictions. The top panel shows the relationship in levels across countries, and the bottom panel shows the relationship in differences over a period of at least five years

Capital Account liberalisation, Inequality and Poverty

Gini Coeffcient | **Average incomes in bottom quartile** | **Share of Population below dollar-a-day**



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William Larralde
Group of 24

The Cobham paper maintains that the capital account liberalisation (CAL) process makes the task of developing country governments much more difficult, by demanding market-friendly policies that ensure macroeconomic stability, promote growth and fight poverty, in an environment of greater financial volatility brought about by an enhanced integration into, and dependence on, the international private financial markets.

It is worth noting that this is usually further complicated by the fact that such liberalisation occurs in the context of:

- a liberalisation of policies and regulations related to the domestic financial sector and to the trade of goods and services, including financial services;
- in most cases as part of an economic adjustment programme in an adverse national and international economic environment in terms of slow or negative growth;
- difficulties for servicing domestic and external debt;
- deteriorating terms of trade;
- balance of payments difficulties;
- no or limited access to financial markets and the likes.

It was in recognition of the varied set of conditions in different developing countries and regions of the world, that the G-24 itself made public early-on in the discussion on CAL its stand for an orderly, cautious and gradual approach (Caracas Declaration, February 1997). This declaration was made at a time when the so-called 'international community' was still pushing resolutely for an amendment of the IMF's Articles of Agreement, in order to extend its mandate over members'capital account regimes with a view to furthering CAL in all member countries (meaning developing countries and countries in transition).

Going to the paper's central argument that CAL negatively affects prospects for growth and poverty alleviation even in the event of capital inflows, the implied conclusion seems to be that the current instability of international private capital flows to developing countries is such that management of economic and financial policies to harness it becomes the main task of public policy in developing countries to the detriment of pro-poor policies and programmes and to the anti-cyclical macro-management of the economy. If such a conclusion is accepted,one can also posit that any status quo, regarding the financial sector and the capital account in any developing country, is preferable to full financial liberalisation or possibly even to a partial liberalisation.

There is a basic flaw in such a reasoning,which is the assumption that the pre-existing set of conditions — before CAL — were conducive to sustained economic growth and poverty eradication. In this regard I would like to expand on several considerations relevant to the appraisal of the impact of CAL on poverty in developing countries.

The analysis assumes optimistically that the governments of developing countries were reaching the poor and that poverty eradication was a primary goal of their policies.The reality is radically different: governments in developing countries respond to similar "power"and "real-politik" motivations as in the rest of the world.

Focusing on the poverty impacts of macroeconomic policy may ignore more important causes of poverty. I believe that too much is being expected from macroeconomic policy, particularly from the macro-policy prescriptions of the IMF, for poverty eradication,with very little chance of success.This is not to say that I am suggesting that the consequences of alternative macroeconomic policies on income and wealth distribution should not be studied,measured and included as a fundamental criterion for decision making; nor that macroeconomic policy is neutral to the particular interests of particular groups. Rather, that in most cases, the root causes of poverty are not being attacked,not even analyzed in depth. For example, those deriving from population pressures, the highly skewed ownership of assets such as arable land, and in general the mechanisms of distribution of income and wealth that have persisted in today's poor countries over many decades, if not centuries.

The push for the formal inclusion of CAL and financial sector opening as a mandate to be inserted in the IMF Articles of Agreement is being replaced by a more subtle mechanism, such as embedding the same objective into the adoption of international standards and codes, best practices and the like, which are being formulated without adequate participation of developing countries in inter-governmental and non-governmental bodies and also through WTO commitments regarding financial services, trade related agreements, etc.This takes me to the most fundamental matter of the necessity to establish a set of global rules and institutions for governing the functioning of the global economy. I will not expand on this at this time,but simply assert that the governance of the international financial system is at the lowest end of priorities for reforming the international financial architecture, yet, the working of financial market forces are among the strongest, the fastest, the most unstable and the most harmful expressions of globalization.

Whatever the merits or demerits of CAL for economic development in developing countries, LDCs or MDCs, the fundamental problem is that the international monetary and financial system is dominated by three currencies (two national and one regional) which operate with little or no regard for the effects of their monetary policy on the rest of the world. Particularly problematic is the excessive weight of the United States as both the main international currency issuer and by far the dominant importer of capital from industrial, transition and developing countries.

Mark Allen
International Monetary Fund

This paper leaves me thinking that tracing the relationship between capital account liberalisation and poverty is too ambitious a task. It is remarkable how little we know about the relationship between macroeconomic policy and poverty, or for that matter what government expenditure policies help the poor in the longer run;indeed,there are those who argue that the link between growth itself and poverty reduction is tenuous. If these basic building blocks are not in place, it is going to be difficult to establish the long chain of causal relations between the restrictiveness of the capital account and the incidence of poverty.

Broad cross-sectional regressions of growth on indexes of capital account openness do not support the hypothesis that capital account liberalisation is good for growth.But this finding provides no support for the hypothesis that the poor would benefit from maintaining a restrictive capital account regime.All that these regressions tell us is that the relationship between capital account liberalisation and growth, if any, is obscured by the absence of other variables in the regression that also have a bearing on the interaction of capital account liberalisation and growth.

We have learned that there are at least four circumstances in which opening up a country's capital account can be inappropriate, if not disastrous.When:

- prices are distorted and the current account restricted;
- the country faces major macroeconomic imbalances;
- domestic banks are insolvent;
- prudential regulation of banks and markets is inadequate.

In addition, there have been lessons about the sequencing of capital account liberalisation itself. The relevant question now is how capital account liberalisation that takes these lessons into account affects growth or poverty.

There are many channels by which capital account liberalisation may affect growth and the poor negatively.There are likewise many channels by which capital account liberalisation would facilitate growth.Which dominate in practice,and are there ways of both having your cake (*i.e.*, the positive effects of liberalisation) and eating it too (*i.e.,* avoiding the negative consequences)?

Capital account liberalisation is a further step beyond domestic financial liberalisation, and the latter can help or harm growth and the poor in the same ways that the former can.Indeed,the record of severe domestic financial crises following domestic financial liberalisation in both industrial and developing countries is remarkable. Nevertheless,as Cobham points out,the evidence shows clearly financial liberalisation is conducive to growth and the reduction of poverty.Why then, would we not expect capital account liberalisation in the appropriate circumstances to have a similar positive effect on balance?

Cobham applies a "precautionary principle"to the issue of capital account liberalisation: since there is no evidence that liberalisation leads to growth, and there is evidence of it being accompanied by crises that have certainly hurt the poor, liberalisation should be avoided.The paper does not tackle the other side of the question,which is that there is evidence that the use of capital controls has not helped countries avoid crises, that they have been costly, and that they breed corruption. Edwards points out that Korean policy makers in 1997 and Brazilian policy makers over the same period believed that the controls on inflows they had in place would protect them from the crises which nevertheless hit them.[1] He also notes that the Latin American countries which tried to strengthen capital controls in the 1980s, Argentina,Brazil,Mexico,and Peru, were the ones to suffer the most prolonged recession and most rampant inflation during the decade. By contrast, those which avoided controls and also did the most to restructure their economies, Chile and Colombia, were the only ones to show any growth in the decade. Russia might also be cited as an example of a country where extensive capital controls not only do not prevent capital flight,but provide a major vehicle for corruption.

Anecdotal evidence does not support the idea that those countries which maintain restrictions are more successful at combating poverty. Their relatively closed capital accounts may have helped shield India and China from the Asian crises, and the countries have managed to grow relatively fast in the presence of controls.However, if the World Bank's statistics are to be believed, neither has been particularly successful in reducing the numbers of the poor.

These examples do not of course prove that capital controls are universally harmful, but they do indicate that one should pause before recommending their use. To make a useful contribution to policy formation, we need to come up with more specific advice about the sort of restrictions that are appropriate in different circumstances.

One of the main channels that Cobham identifies by which capital account liberalisation may affect the poor is the constraints it puts on expansionary domestic policies and in particular on government spending.Capital restrictions can restore some autonomy to domestic macroeconomic policy and allow it to be directed towards poverty reduction. There is some evidence that public spending is lower in countries where the capital account is more open.[2] The case is also based on Krugman's "impossible trinity", that a country cannot have an open capital account, a fixed exchange rate, and autonomous macroeconomic policy simultaneously.

The Krugman argument provides a useful model for recent crises. In each, the capital account was more or less open,and each was trying to defend a fixed exchange rate.In the end,the political strains that the resulting domestic policies created led to an abandonment of the peg. Post-crisis, most countries have opted for capital account liberalisation and a floating exchange rate, but this should have restored their macroeconomic autonomy. Whether any relationship between capital account liberalisation and the level of public spending persists in a world of flexible exchange rates remains to be seen.But if the Krugman model holds, we would expect the relationship to be weaker in the future,as well as the incidence and costs of crises lower.

A similar line of thinking leads to the conclusion that the problem of capital inflow surges is largely a matter of the past.These episodes were generally associated with the use of disinflation strategies involving an exchange rate peg and tight monetary policy. This combination created the incentives to pull in large amounts of short-term capital, in turn vitiating the macroeconomic policy stance. The improved economic management exhibited by many emerging market countries has reduced the amount of disinflation that remains to be done,and fixed exchange rates are now much rarer. It should be possible to handle future cases of excessive capital inflows by allowing the exchange rate to appreciate.

The seriousness of the capital account crises of 1997-8 is without question. The current accounts of the Asian countries affected moved in the crisis year by 10 percent of GDP, thanks to the size of the outflows. In such circumstances,real incomes must fall until GDP can recover, and the challenge is to protect the poor in this process. Social expenditures were among those least affected by the programmes,although they could not hope to shield people from all effects of the crisis.

The programmes were not focused on the achievement of fiscal balance. Initially, when the depth of the crisis was not yet evident, the only fiscal tightening prescribed was that needed to offset the carrying costs of the new debt incurred from recapitalizing the banking system. Fiscal policy was intended to be neutral. But when the depth of the likely fall in GDP and in government revenues became apparent,the programmes were rapidly redesigned to allow the automatic stabilizers to operate.

It is an interesting question whether a larger fiscal deficit is the appropriate response to a depression. This is clearly the Keynesian solution and works in most industrial countries. It works because the stimulation of the more expansionary fiscal policy is not offset by a loss of confidence in policy sustainability. Investors and consumers have confidence that the increased government debt will not be inflated away, but will be honored.This is not necessarily the case during a capital market crisis in an emerging market. It is quite possible that the expansionary effect of a larger deficit will be more than offset by further capital flight if investors fear that it signals a significant rise in inflation.[3] This is a case where capital controls might help, providing that the short-term gains offset the medium-term costs of their imposition.

Endnotes

1 Sebastia
Edwards,
Mirage of Capital Controls, mimeo, M
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2 Barry
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3 See Barr
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mimeo,
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I have been asked to focus my comments on crisis periods. Let me begin by indicating that I agree with the overall thrust of the paper and recognize and appreciate the important potential contributions it is making given the paucity of research and analysis on this topic and the urgent need for more of both,especially from a developing country perspective.

Major Overall Comments

Notwithstanding the acknowledged global importance of the Asian crisis experience, and the lessons learnt from it, it is important to examine empirical evidence on the impacts from other recent and different financial crises (e.g.Mexico in 1994-95,Russia in 1998) in the South and East.To understand whether the effects of other crises are consistent with and reinforcing of those from the East Asian crisis.

There is a need to differentiate the poverty, employment and other structural and social impacts of the crisis much more between North East and South East Asia and between short term and long term impacts. For example, these impacts in the Republic of Korea have been significantly different from those in Thailand and Indonesia in terms of their structural nature,severity and length.

Social and Structural Impacts

It is important to understand the short and long-term structural inequality implications of the crisis, not just its poverty implications. Some of the more significant broader social implications of the crisis, for example, the enormous reverse migration that took place in Thailand and the social dislocation and reduction in remittances from urban to rural areas that accompanied it, and the breakdown of the historical government compact with labour in the Republic of Korea, also need to be understood.One of the most far-reaching structural and social implications,especially for poor and marginalized population groups in Thailand, has been the privatisation of some of the more efficient, profit-making public utilities to finance the budget deficit.

Poverty and unemployment are inextricably linked, hence the monetary (e.g. interest rate) trade off between inflation and employment is crucial. While inflation does obviously hurt the poor, most people if they were polled would rather have employment with higher inflation than the other way around, for obvious reasons.In this context,the deflation,with significant increases in unemployment and underemployment, which occurred as a response to the crisis in countries such as Thailand, directly and severely exacerbated the poverty crisis. This is particularly so in countries where there are no effective formal social security and insurance systems except employment.

The incidence of underemployment in all the Asian countries, especially in SE Asia, with its direct poverty, inequality and social implications was much more severe than formal unemployment figures would have us believe.Closely related was the increased informalisation of the work force with its much more severe and largely undocumented poverty, social dislocation impacts and coping and survival strategies.

It is also important to consider social investment funds (SIFs) because they were the major poverty response mechanism of the Bretton Woods institutions (BWIs), ADB and governments. The very nature of their basic assumptions and design ensured that their impact on structural unemployment or underemployment and therefore poverty – in the short-term,let alone the long-term – was negligible.

From Financial Crisis to the Real Economy

It is crucial to emphasise that what began, especially in the Republic of Korea (but also in Indonesia and the Philippines and to a lesser extent in Thailand), as a private sector crisis of illiquidity in the financial sector, was quickly and unfortunately converted into the twin crises of both the private and public sectors as well as a structural crisis of both the financial and real economies because of the nature of the donor and government policy response to the illiquidity crisis.This policy response has to be blamed for the much more serious,widespread and longer poverty and employment impacts than a much more containable private sector crisis of illiquidity in the financial sector would have entailed.

The Linkages Between Trade and Financial Liberalisation

The relationship between trade and financial liberalisation needs to be explored for a number of reasons, not least to understand why there has been such a vocal and impassioned critique of capital account liberalisation by ardent and influential "free trade" advocates such as Dr. Jagdish Bhagwati of Columbia University. However, equally, if not more importantly, this relationship needs to be explored because of the empirical evidence from the SE Asian crisis,which clearly showed that trade liberalisation policies in the context of financial liberalisation can also severely exacerbate poverty, inequality and other social impacts even if the proximate primary cause of the crisis was capital account liberalisation.

In the case of Indonesia,its capital account liberalisation crisis exposed the vulnerabilities and shortcomings of its trade liberalisation policies, highlighting and bringing into sharp focus the poverty, inequality and social impacts of the latter much more clearly. I am referring here specifically to the food security and medicine crisis, which became evident in Indonesia soon after its financial crisis. Trade liberalisation policies,which had increased Indonesia's dependence on basic food and pharmaceutical imports, started to look particularly misguided from the perspective of poverty, inequality and increases in social chaos when the severe devaluation of the Rupiah against the US$ meant that basic food and medicine became unaffordable and even unavailable to the majority of the Indonesian population, particularly the poor and most needy.

The Thai crisis was clearly created and fuelled by a national economic growth strategy which was heavily dependent on the twin external, unsustainable and often contradictory engines of trade and capital account liberalisation.The causes, severity and poverty, inequality and social impacts of the 1997 crisis were a result of the simultaneous twin crises of the country's export competitiveness strategy, in the context of trade liberalisation by countries such as the People's Republic of China, and its premature and unregulated capital account liberalisation strategy.

To elaborate,as I first argued in 1997,when the Asian crisis began in Thailand, (*East and Southeast Asia Revisited: Miracles, Myths and Mirages,* FOCUS Papers,November 1997),the initial success of Thailand's low-end value added, labour-intensive export growth was overtaken by its relatively high labour cost in relation to labour productivity because of the country's failure in its post-primary education policy and pitiful investment in research and training.This has led to the loss of Thailand's export competitiveness,particularly in the much more aggressive global context of trade liberalisation embraced by most developing countries and, especially competition for the same exports at much more favourable labour cost to productivity ratio in the People's Republic of China.

In addition,the relationship between trade and capital account liberalisation is important to explore because in all the Asian crisis countries, but especially in SE Asia,a key and desperate strategy that national governments have attempted to prioritise in their efforts to claw their way out of the crisis is to promote natural resource based exports, which will clearly have both short and long-term negative environment,poverty and food security implications for particularly the poorest population groups in these countries, who are heavily dependent on the agricultural and other natural resource base.

Endnotes

1 The views expressed here are those of the author's and should not be attributed to UNDP.

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Web Resources

www.stern.nyu.edu/globalmacro
Global Macroeconomic and Financial Policy Site run by Nouriel Roubini at the Stern School of Business,New York University, with academic and policy papers,newspaper and journal articles as well as good links to other relevant sites.

www.ids.ac.uk/ids/global/Finance/intfin2.html
Institute of Development Studies (IDS) website on Globalisation and monitoring the International Financial Architecture with IDS papers and links to other websites.

www.odi.org.uk
Overseas Development Institute (ODI) website with information about research programmes and lists of publications and briefing papers.

www.focusweb.org
Focus on the Global South website with information on social and economic impacts of Asian crisis and IMF reforms.See in particular *Prague 2000:Why we Need to Decommission the IMF and World Bank*.

Http://attac.org
Association for the Taxation of Financial Transactions for the Aid of Citizens (ATTAC) website with papers and networking opportunities on currency speculation taxes and other financial architecture issues.

www.twnside.org.sg
Third World Network (TWN) website with information and publications on the Global Financial and Economic Crisis.

www.ased.org
Heinrich Böll Foundation hosts the Asia-Europe Dialogue on alternative political strategies. Contains comments and reports on the social impacts of the financial crisis in Asia and the global financial architecture.

www.devinit.org/findev
DFID funded Finance and Development Research Programme identifying effective financial sector policies for promoting poverty reducing economic growth in poor countries.

www.qeh.ox.ac.uk
Contains research reports on financial sector issues,capital flows and developing countries from researchers at Queen Elizabeth House, Oxford University.

www.brettonwoodsproject.org
Reports and briefings on IMF and World Bank policies and reform options.

www.cafod.org.uk/policy.htm#international
Contains reports and briefings on the social costs of financial crises,in particular see *Capital Punishment:Making International Finance Work for the World's Poor*.

www.obsfin.ch/index.htm
Observatoire de la Finance (Financial Monitoring Centre) provides articles, research and comment on aspects of finance and the common good.

www.fondad.org/published.htm
Forum on Debt and Development site listing useful publications,see in particular *Private Capital Flows to Africa: Perception and Reality*, Nils Bhinda and others,1999.