Go with the flows?

Capital account liberalisation and poverty

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The Bretton Woods Project monitors the World Bank and International Monetary Fund in collaboration with NGOs and researchers.Established by a network of 30 UK NGOs in 1995,it circulates information undertakes research, and advocates for change in these institutions.Issues it has addressed include structural adjustment programmes, conditionality, the World Bank/IMF growth model, and a number of controversial projects.

The Project produces a regular bulletin, the *Bretton Woods Update,* which is available in print, email and web versions.

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About Oxfam

Founded in 1942,Oxfam works with poor people regardless of race or religion in their struggle against hunger, disease, exploitation and poverty.

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A full transcript of the meeting is available at www.brettonwoodsproject.org.

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Preface

G7 Finance ministers and central bankers meeting in Palermo, Italy, on February 17,2001 have committed themselves to meeting the United Nations international development goals by 2015. The goals include halving the proportion of people living in extreme poverty, achieving universal primary education and reducing by two-thirds infant and child mortality rates.According to the ministers'statement,a three-pronged strategy to reduce poverty involves:

- creating a more favourable environment for attracting private investment flows into the poorest countries;
- channelling more resources,in a more efficient and coordinated way, to the social sectors through country-owned poverty reduction strategies;and
- a new multilateral trade round and opening markets in developed countries to exports from the poorest countries.

The ministers' commitment to fight poverty reduction is welcome. Facilitating private sector investment and more social spending are undoubtedly important aspects of a strategy to do so. However, if capital account liberalisation (CAL) is to be a central element in attracting foreign private sector flows then there is potentially considerable conflict between these prongs of the strategy.

The financial crises in Asia, Russia and Brazil contributed to a more nuanced approach to CAL, that is, capital account liberalisation should proceed more cautiously and with the appropriate sequencing to avoid financial crisis. However, there is no evidence that CAL does or does not contribute to poverty reduction and only limited understanding on the transmission mechanisms involved. Yet G7 ministers assume that CAL is an ultimate goal and they are driving the reform agenda forward.What seems to be overlooked is that liberalisation should not be a goal but a means to an end. That end, as the ministers have now endorsed, should be poverty reduction. Yet there has been little analysis of how to sequence CAL to achieve the best outcome for the poor.

What is worrying is that although the IMF has a mandate (whether explicit or implicit) to pursue both financial liberalisation (domestic and capital account) and poverty reduction, it may require governments to prioritise the former at the expense of the latter.Whilst the Poverty Reduction Strategy process emphasises government leadership and civil society participation,the codes and standards being imposed by the G7 through the IMF have neither of these qualities. Neither are they truly "optional" for governments.

Several inconsistencies between CAL and poverty reduction suggest themselves:

- it is questionable whether CAL is a determinant of investment flows and therefore growth and poverty reduction;
- there is the potential that government policy in a liberalised financial climate will be limited in its ability to be pro-poor focused;
- putting in place the appropriate institutions and regulatory measures to govern a liberalised financial system could divert scarce resources away from poverty reduction measures;
- it appears likely that CAL will contribute to greater inequality by benefiting the rich more in good times and hurting the poor more in bad times.

Countries considering further integration with the global financial system need to be able to distinguish between the liberalisation measures necessary to facilitate international trade and investment (and therefore beneficial for a country choosing such a growth path) and those which are not.They also need to be aware of, and have the ability to assess, the trade-offs in relation to pro-poor growth strategies. Capital account liberalisation is not an all or nothing process,and there are lessons to be learnt from previous experiences of liberalisation.

Prompted by these concerns, in January 2001 the Bretton Woods Project and Oxfam organised a meeting[1] with Non-Governmental Organisations, academics, civil servants and staff from the World Bank,International Monetary Fund (IMF) and other international institutions to discuss the linkages between capital account liberalisation and poverty reduction. The meeting, held at Queen Elizabeth House, Oxford University, was concerned with identifying the potential linkages through government policies and through impacts on sustainable livelihoods.The meeting was a useful starting point and highlighted that there are many more questions than we have answers to.This report does not attempt to provide those answers but to suggest some transition mechanisms through which CAL might impact on the poor.

Part 1 is a summary of the discussions at the Capital Account Liberalisation and Poverty meeting (for a list of participants see the end of this publication). Parts 2 and 3 are the paper and critiques prepared for the meeting.

Angela Wood, Bretton Woods Project

1 Thank you to the Department for International Development for their generous support,which made this meeting possible.

From Capital Account Liberalisation to the Real Economy: Putting People First[1]

Angela Wood, Bretton Woods Project

1 Push Factors for Capital Account Liberalisation

Recent decades have seen a range of pressures on developing countries to open up to foreign capital flows: through World Bank and International Monetary Fund (IMF) conditionality, World Trade Organisastion (WTO) rules, membership of the Organisation for Economic Cooperation and Development (OECD),or membership of regional trade arrangements. Financial integration, it is argued, is both good for growth and necessary to co-ordinate participation in international trade and investment.

Since the South East Asia crisis and the subsequent crises in Russia and Brazil there has been some rethinking about domestic financial and capital account liberalisation. Whilst there is now a commitment to proper sequencing and pacing of reforms there remains the implicit (and often explicit) assumption amongst the G7 governments and the leaders of the International Financial Institutions (IFIs) that countries will move increasingly towards full liberalisation. However, outside these circles there is a growing acceptance that the arguments for CAL are not well founded and that the liberalisation process needs to be seriously reconsidered.

Whilst there has been a back tracking from formalising CAL through the IMF's articles of agreement[2], instead,as William Larralde pointed out,it is being pursued by stealth,"[it] 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".

1.1 Private Capital as a Substitute for Aid Flows

A justification for pursuing liberalisation is that it is necessary to attract private flows to substitute for declining aid flows. Capital account liberalisation helps create an attractive environment for capital. The market, it is argued, will ensure that resources flow from countries with high savings (i.e. investable resources) to those countries with low savings but profitable investment opportunities. In so doing there will be benefits to the rich country investors who can diversify their portfolios to reduce risks and find more profitable investment opportunities and the poor countries will gain access to funds for investment and therefore growth.

In reality, whether private capital can substitute for development aid will depend on how individual developing countries manage the integration process and what policies they have in place to attract, manage and direct flows.The distribution effects of financial opening will likewise depend on the nature of liberalisation and who can benefit from it. While empirical evidence on the gains from financial integration in developing countries is hard to find,the recent financial crises in East Asia,Russia,and Brazil have made the risks all too apparent.

1.2 Linkages Between Trade, Capital Account Liberalisation and the Balance of Payments

For some, liberalising the capital account is the natural extension of liberalising trade,although,it has been widely acknowledged,even by free trade advocates,that there are not the same strength of arguments for doing so[3].

As Matthew Martin argued, in the poorest countries,where regulations and monitoring are minimal, there may be little choice but to liberalise the capital account if the trade account is liberalised, since transfer pricing and other practices allow companies, particularly multinationals, to move capital in and out remarkably easily.

A more positive argument provided by Mark Allen is that, "The greater degree of current account integration now prevailing throughout the world and changes in technology have helped change the arguments for capital account liberalisation. Competitiveness pressures may be greater with trade liberalisation, and a firm in a developing country may require access to more extensive banking services and cheaper capital. Such considerations have led countries to remove some restrictions on cross-border banking activities and to deepen the pool of capital that their firms can tap. At the same time, it has become much easier to circumvent capital controls, firstly because of new technology, but also because it is easier to hide capital movements in the huge volume of trade".

Capital inflows facilitated by CAL have allowed countries, for example Thailand, to mask or cope with increasing trade and current account deficits brought about by trade liberalisation since the inflow of capital has allowed countries to achieve an overall balance of payments. The problem is that once capital has been attracted in, if there is no improvement in the trade account, then the country must continue to attract new inflows and it will remain sensitive to any outflows. Thailand's mounting trade deficit was not problematic until investors judged it to be too high and withdrew their money.

CAL can also contribute to trade account pressures if inflows cause exchange rates to rise as Men Sta Ana argued: "In turn, the strong or overvalued currency undermines the real sector of the economy. Both exports and import substitutes are penalised. 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 nontradables. 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 nontradables such as utilities, telecommunications, transportation, and real property".

Exporters may generate internal pressures for CAL. Allen suggested that "What tends to happen is that local firms engaged in the export business are looking, for example, for hedging functions of banking services which the banks can only provide if there is some liberalisation in the capital account. If these demands are not met, then the costs are higher for local businesses than for foreign companies, which have access to certain resources and financial facilities abroad".

In crisis periods the links are particularly problematic. Reflecting on events in Indonesia, Kamal Malhotra suggested "the translation of the capital account liberalisation crisis into an exacerbation of the effects of trade liberalisation policy, was fairly stark. The effects on prices - various food prices and their availability, what happened in terms of medicine availability etc - and the differential impact of that in terms of the poor versus the rich are fairly clear. This may be seen by some as two separate things, trade liberalisation and then financial liberalisation, but when you have a crisis in one area, how does that actually impact on policies in the other area and exacerbate or highlight some of their downside effects?". And, "the other side of this - again in the case of Indonesia and Thailand - is the desperate attempt to use natural resource based exports to claw their way out of the crisis in terms of generating foreign exchange".

1.3 Linkages Between Privatisation and CAL

A further pressure for capital account liberalisation has been privatisation. Many countries have reformed investment rules to allow foreign ownership of domestic enterprises and utilities. This has often been the thin end of the wedge driving further liberalisation of the financial sector to allow international trade in stocks and shares and the development of stock markets.

This process was invigorated in Thailand, South Korea an Indonesia in response to the crisis. Deeper liberalisation to allow the sale and foreign ownership of national enterprises was a key condition for IMF bail-out assistance.

2 From Capital Account Liberalisation to Poverty: Identifying the Linkages

The linkages between CAL and poverty are not direct. Whether CAL has an indirect effect on poverty depends on whether liberalisation generates incoming flows, how these flows are absorbed in the economy and whether they are available to the poor and small and medium enterprises, i.e. do they support pro-poor growth. In addition liberalisation can have indirect impacts on government policy through governments' efforts to encourage and maintain flows. Indeed, there are more direct roots for affecting poverty reduction.However, it is important to understand that macroeconomic policies do have income and distribution effects and how they may or may not support a pro-poor strategy. The concern is that CAL should not foreclose these more direct means or worsen the poverty/inequality situation.

Fernando Carvalho reflected that it is important to distinguish between two types of poverty: that which stems from low income and that which stems from inequality. For the former, growth may be the priority, but in the latter, how CAL impacts (directly or indirectly) on the distribution of opportunities and wealth is important.

Not only does CAL bring potential opportunities it also creates the potential for crisis.Thus,it is important to consider what the net effect on poverty may be and whether the effect is asymmetrical,i.e.do the poor benefit less in good times and suffer more in bad?

Charles Abugre remarked that whilst the poor are likely to benefit in good times, through higher wages and asset prices, these benefits are only temporary and are reversed in bad times. It is not clear then what the overall impact is on the poor in the long run.As Frances Stewart pointed out, in a crisis the scale of losses felt by the poor are not likely to be as great as those experienced by those who are more wealthy. However, the concern is that the poor are less able to recover. The overall impacts on inequality could be expected to be negative for the poor (both in good and bad times) but further investigation is necessary to prove this.

As with other adjustment policies, it is clear that some sections of the poor are likely to benefit or lose more than others. It is not helpful to aggregate the poor as one group. For example, the impacts need to be understood in terms of their effects on the rural and urban poor, those engaged in production for export markets and those engaged in domestic or subsistence production and on the different elements which contribute to poverty.

2.1 Liberalisation, Resources and Growth

Participants broadly agreed that growth is an important element of a poverty reduction strategy, particularly for the poorest countries.Therefore it is pertinent to consider whether CAL contributes to growth.

The IMF supports CAL on the basis that it helps to attract in more resources for investment which can be positive for growth[4]. However, as Aart Kraay remarked "the difficulty with that argument is that the one thing that's been laboured at length before, correctly, is that capital controls in most cases are not the binding constraint on investment in a country. Bad domestic policies can take much of the blame. And the second point that hasn't been discussed,but it's worth putting on the table,is that there's actually surprisingly little evidence that investment raises growth despite what we all like to say".

These views are supported by Alex Cobham's review of the literature which concludes that there is no *a priori* linkage between CAL,inflows and growth. However, whilst new foreign inflows may not be forthcoming, liberalisation may be expected to encourage flight capital[5] to return, which may be the most stable and "pro-poor" inflow associated with CAL.Louis Kasekende pointed out that this is Uganda's experience: "Conversely, most of these [African] countries [with capital controls] 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".

One aspect of CAL which may limit the potential for increased growth or even reduce it,particularly in the sectors important to the poor such as agriculture, is volatility[6]. Cobham points out in his paper that as it becomes easier for capital to flow in and out of a country, volatility in the macro-economy increases, leading to greater uncertainty. This may constrain the investment decisions of smaller firms in particular. Whilst larger firms and investors are able to make use of international capital markets to hedge against risks and uncertainty, this option is often not open to smaller businesses and investors. This is confirmed by Kasekende who noted that liberalisation has led to greater volatility of prices; "it is extremely difficult to think of any insurance scheme at the level of the peasant farmer to hedge against that risk", and "the volatility in the exchange rate has affected viability of a number of small-scale farms".

Contagion creates an additional source of volatility. Brazil is a good example. To maintain its inflation control policies, which relied on a fixed exchange rate, in a liberalised environment, the government was repeatedly forced to raise interest rates to 40 percent and over to address volatility caused by crises in Mexico and Asia. In addition to the uncertainty about the level of interest rates, high rates can be expected to discourage all but the most profitable investments.

Carvalho suggested that, "interest rates [in Brazil] tend to be on average higher than is considered sustainable, because the repeated experience with increasing rates feeds a kind of bearish sentiment in terms of interest rates. Everybody knows that at any time interest rates can be raised again if you have a serious crisis in Argentina or in any other place. So you tend to have a situation where either interest rates are kept too high or maturities are kept too short because nobody will commit resources at low interest rates to longer periods if you know that you are subject to this kind of volatility".

Since CAL is unlikely to have a significant positive impact (and may potentially have a negative impact) on poverty reduction through growth, it is important to consider whether it has an impact through the distribution of income and wealth and access to basic services, i.e. on government spending.

2.2 Access to Capital Flows and Impacts on Assets

The benefits from liberalisation appear to be mostly related to the efficiency with which domestic markets can allocate capital. However, efficiency is understood in terms of the profitability of investments, not their potential to reduce poverty. If we take the latter as the primary objective then do we see benefits to liberalisation? Or perhaps more specifically, when are there benefits to liberalisation and should it be a priority for governments with few resources, little capacity and high levels of poverty?

Liberalisation Episodes: When Capital is Flowing in

When new capital flows in, who gets it? Stewart remarked that "it seems very unlikely that the poor are going to get it dis-proportionally to their initial share of income, it seems almost certain that they won't. Also, there is rather clear evidence of a lot of it going into land speculation in the urban areas, so it seems likely, unless you have very tough intervening policies, that that side of the channel would not be positive for the poor".

Martin insisted that it is important to distinguish between the types of flow and to track them to determine their various impacts. For example, the distributional impacts of flows and their transmission mechanisms through employment, labour policies, wages and access to land and so on, particularly need to be understood[7]. This will be necessary to determine whether there is an optimum mix of flows that can reduce volatility and increase benefits to the poor, as Abugre suggested there might be. For example, Martin considered that the impact of "private transfers" i.e. domestic capital flight which tend to flow back to the home economy after liberalisation, are much more likely to have a positive impact on poverty reduction because they tend to go to people creating small to medium enterprises or building houses, using largely local materials etc. It is likely that those flows are much more pro-poor. Alternatively, if a government, in order to sell a parastatal utility to a foreign investor, abandons all pro-poor regulations which ensure their access to the service, that is a direct impact of foreign capital flows on the prospects of future poverty reduction.

It was generally agreed that it is important not to simply assume that Foreign Direct Investment (FDI) is basically good,and thus different types of FDI into different sectors must be distinguished. In addition,it is important to understand whether the beneficial flows actually are facilitated by financial liberalisation. If not, there may be few benefits of liberalisation but many potential costs, particularly transmitted through higher exchange rates,interest rates and volatility.

Even if liberalisation (both CAL and domestic financial liberalisation) does not actually draw in more capital it could lead to a change in the internal allocation of capital.Cobham's paper addresses this in part 4.In particular, there is the potential for increased competition between banks and other financial institutions to skew resources away from rural areas to urban centres and from small and medium enterprises to large corporations.

Another factor which needs to be examined,as Stewart suggested, is whether those with more assets are likely to benefit more. For example, there is evidence from Kenya that after domestic financial liberalisation many poor people were denied access to basic bank services because their savings/assets were too small.[8]

Crisis Episodes: Capital Outflows

In a crisis situation, Malhotra considered that the rich might be better able to protect their assets. He considers the problem from the perspective of the ability to relocate savings, i.e. in terms of whose assets are more mobile: "In the case of Thailand, even before the crisis,a certain group of people close to the government, close to the policy makers, in fact big business, relocated their money before the devaluation. They were able to relocate their assets because there was a liberal capital account".

In the case of Mexico, Valpy Fitzgerald pointed out that when per capita national income regained its pre-crisis level it was with greater inequality, "it shows there's a permanent poverty effect, in the sense that the same income levels will generate a larger level of poverty and that has a lot to do with the asset effect".

Alternatively,Aart Kraay argued that crises could have an equalising effect. He points out that the gini-coefficients, which measure wealth inequality, declined between 1996 and the end of 1998 for Indonesia, Korea and Thailand; the two numbers respectively, are 38 and 37, 30 and 29 and 43 and 41. He offered anecdotal evidence that the poor were able to benefit from falling asset prices in Thailand during the crisis;"There were cases of farmers coming into the capital city to take advantage of the fact that there were sales on Mercedes.All these people who had made a lot of money speculating on real estate and were really hurting, were selling off Mercedes at bargain basement prices".

However, it is not surprising that some sections of the poor may well benefit whilst others suffer. For example, in Thailand, it may well be that farmers producing for export benefited, whilst those who were not, i.e. smaller farmers did not.This suggests that its not simply a question of looking at who wins and loses in terms of income quintiles, impacts on sub-groups of the poor need to be examined. Also, as Stewart pointed out, how quickly and to what extent are the poor able to recover compared to the more wealthy? In relation to this it will be important to investigate whether the poor are forced to sell more of their assets (relatively) during and after a crisis and whether the value of the poors' assets decline faster or slower than those of the rich, and whether there are longer term income and employment impacts (in both the formal and informal economies) for the poor.

Government Intervention

Many agreed with Stewart that,"intervening policies to direct capital more to the poor are hugely important".Kasekende remarked that the task for governments was to find policies that were market friendly but which could accommodate the needs of the people.

One means for improving the usefulness of capital inflows is to direct them to priority sectors i.e.to adopt proactive investment promotion policies. If the objective is poverty reduction these might focus on the agricultural sector and rural enterprises and small and medium sized firms. However, liberalisation has meant the dismantling of most investment boards which have been replaced with "hands-off", "one-stop" investment shops the only function of which is to facilitate investment with no consideration for the quality.

Jonathan Leape argued that it is a misconception to view financial liberalisation as a retreat by government:"Liberalisation is primarily a retreat from certain types of means for achieving certain types of ends, but the ends haven't changed very much.If we think of capital controls,the objective was not the control in itself of course, but the desire to try to insulate the economy to some extent from these external shocks. That objective is still there. If we think about provision of credit to rural areas, yes some pretty ham-fisted and heavy-handed mechanisms were used in the past to do that,but that's still an important objective". There needs to be "more emphasis and more creative thinking on new, market-compatible ways of achieving these same objectives. So recognising for example,that you can no longer rely on banks to cross-subsidise loss-making loans to small business into rural areas, we need to think in terms of explicit subsidies from government".

Angela Wood suggested that directing and/or maintaining credit to vulnerable groups and firms in times of crisis was equally important, which suggested that Governments should establish mechanisms in good times which could be scaled up in times of crisis.

However, its not simply a matter of ensuring access to capital but also maintaining access to basic assets. Regulations, such as land reform and tenure policies, need to be implemented which protect access of the poor to basic assets.

2.3 Changes in Government Spending

Poverty is not simply about income, it has many aspects, including issues such as access to basic services.In this regard,impacts on social spending can have direct impacts on the poor. Fitzgerald posed the question that if you assume that in the downswing the poor are negatively impacted because of the impact on government budgets, amongst other things, then does the upswing period have a positive impact on budgets which would make the impacts more symmetrical rather than asymmetric? One aspect that could limit the potentially positive upswing effects is market discipline on government budgets. This limitation may not be so severe if government revenues increase in the upswing (or if they are more propoor focused). A question that needs to be looked at then,is whether this potentially positive impact is curtailed by competition amongst countries for investment which limits governments' ability to generate more revenue from foreign investors.

It would be naïve to assume that governments are necessarily operating pro-poor policies with capital controls. Indeed, Kraay's paper, given the limitations with the data that he identifies, suggests that although countries with capital controls tend to have higher fiscal deficits there is no relationship between total government spending and social spending between countries that have open capital accounts and those who do not.However, will CAL reduce the opportunities for governments to increase spending on the poor (in particular) in the future? As Malhotra remarked,"if, as a result of CAL and the market discipline kind of argument, and equally importantly as a response to crisis, pro-poor deficits are not allowed, or significant deficits to either protect expenditure or increase expenditure are not allowed,that's much more important".

Several participants remarked that taxation is often not the most effective means of redistributing income, government spending is much more important. Unfortunately, as Cobham's paper notes, pro-poor government spending could be seriously impaired by CAL,because:

- government resources are redirected to other purposes;
- government spending will become more volatile as the economy becomes more volatile;
- opportunities for raising revenues are reduced through competition between countries for investment flows;
- the size of budget deficits and ability to raise extra tax revenue may be constrained by market sentiment (discussed in section 2.4).

Redirecting Government Spending

As the Cobham's paper identifies, several mechanisms suggest themselves by which government spending on social services, for example, may be reduced or diverted these include:

- implementing codes and standards;
- the costs of sterilisation and reserve accumulation;
- higher debt servicing costs (in good and bad times).

If countries are to benefit from capital account liberalisation and capital inflows, then they will need to develop appropriate regulatory and monitoring mechanisms and institutions, and capacity to manage inflows. This will require a substantial amount of financial resources as well as government staff time and capacity. Whilst poor countries might be able to divert resources to these areas, it raises the question of where they are being diverted from, and could they be utilised for more directly pro-poor activities. Certainly, there may only be a few cases of governments which are already focussed on poverty reduction, but diverting resources to implement certain codes and standards is not going to encourage others to address poverty reduction. Martin suggested that donors must be prepared to provide the financial and technical resources to allow poor countries to invest in these areas. To prevent that much needed aid resources are not diverted from other pro-poor uses, technical assistance budgets should be refocused.

Cobham's paper points out the costs of sterilisation and reserve accumulation[9]. Allen argued that sterilisation will be less important in the future: "A similar argument on the question of sterilising inflows, is that all those cases of import surges – which were the big issue in the first part of the 90's – were largely cases where the countries were disinflating from very high inflation rates, using the fixed exchange rate regime, whilst trying to maintain domestic policy autonomy - in this case raising interest rates to try to disinflate. It was in that environment that we found this problem of the capital inflows coming in under sterilisation which was described in Cobham's paper. Now, most of those high disinflation problems have been removed and these countries are now generally on flexible exchange rate systems, I think the sterilisation dilemma, if it emerges again, will probably be dealt with by allowing exchange rate depreciation, rather than trying to maintain a fixed exchange rate and then coping with the capital inflows through sterilisation. So I think there is some reason to believe that both those cases represent problems of the past, rather than the future".

However, the need to maintain large reserves is a significant cost for governments, diverting resources away from other uses and this problem will remain.

External and domestic debt servicing costs could increase via two routes after CAL: if it leads to a rise in the domestic interest rate; and if a government must borrow to overcome a crisis. If budget deficits are constrained because of market discipline or IMF conditionality, the impact of higher debt servicing costs will be cuts in other areas. [10]

In crisis periods, its very clearly the case that government spending on social sectors declines[11], although, as Allen argued, the Bank and Fund (and other regional development banks and donors) have made loans and in some cases grants available to maintain spending and implement social safety-nets. In Thailand, the government also supplemented its budget, as Malhotra pointed out, by selling public utilities: "The reason they were sold was that they were profitable, and so you could have one off income effects or revenue effects for the budget. Obviously this has major long term implications, structural as well as social".

Maintaining social spending during crises in these ways is likely to have negative effects on future spending. Social spending during the Asian crisis was maintained at the cost of building up considerable debts. Governments also incurred massive debts to bailout investors and the banking sectors. Whilst the IMF eventually allowed the Asian crisis countries to increase their budget deficits during the latter part of the crisis[12], in the recovery period, the IMF has insisted that budget deficits are reduced. With enormous debt burdens governments have no alternative but to cut spending in other areas, this has been the situation in Indonesia[13].

In addition to the debt burden, donor financing of the social sectors has structural implications. As Malhotra pointed out, "The nature and composition of this funding has also helped erode the government's capacity for national policy making, coherence and long-term planning in crucial social sector and human development programmes and expenditures".

Volatility of Government Spending

As the volatility in the economy increases so too does the volatility of government spending because:

- revenues are more volatile;
- the amount of reserves that must be held is volatile;and
- prices are more volatile.

Chris Adam reflected that the issue of volatility is indeed extremely important, because volatility in capital flows alters both the volume of the tax base in a way that may be destabilising, but also the purchasing power of the tax base. The latter is affected by changes in the exchange rate that feed through the budget affecting the relative purchasing power of the government and its ability to deliver public services. Changes in the exchange rate could potentially lead to damaging stop/start volatility in public expenditure.In the Asian crisis countries governments' ability to provide adequate social services were impaired by their inability to import, for example,there was a drop off in attendance at Indonesian health clinics because the government could not import drugs.[14]

Adam pointed out that this volatility is worsened by volatility in aid flows: "The one area where there is an important tool for policy intervention is the volume, timing and form of official flows and I think one of the key issues in this debate on CAL and poverty alleviation is: what's the role for government aid? How do you think about the redesign of aid policy in an environment where economies are operating with relatively open capital accounts?"

He suggests that this may be a reason to review the IMF's model: "In a text book model of IMF macro-economic management, the thing that determines the level of foreign exchange reserves that a country would want to maintain in its central bank is to do with the aggregate level of imports. So you want to use foreign exchange reserves to act as a buffer against movements against aggregate imports. But in this [liberalised] environment, if we're concerned about the transmission mechanism through the budget, perhaps we should be thinking not in those terms, but we should be targeting foreign exchange reserves in terms of budgetary volatility. Budgetary volatility that is coming through movements in foreign exchange, private flows, or exchange rate induced foreign exchange." And,"maybe we should be thinking in terms of an environment, or a policy environment, in which governments make use of foreign exchange reserves precisely as a tool to minimise volatility – the transmission of external volatility as a consequence of CAL through the budget – because perhaps it could be argued that that's one area where that volatility is particular costly".

The Cost of Foregone Taxation/Tax Competition

Cobham argues in his paper, that the competition to attract investors leads to a reduction in potential tax revenues. As a result inequalities are likely to increase because the burden of taxation can be expected to fall most heavily on workers because they are immobile,particularly through value added taxes and user fees,which don't just impact on the employed but also the under-employed and unemployed. Sta. Anna took this analysis a step further and pointed out that, inequality is likely to be further increased because taxation will fall on immobile labour, those workers who are unskilled i.e. the poor. Alternatively, Adam suggested that if inflows increase the marginal productivity of labour and the labour tax base, tax rates might decline.

Fitzgerald argued that there is clearly a need for a coordinated response,at least at the regional level, on taxation. Whilst Leape cautioned that transfer pricing would always make it difficult to tax multinationals.In addition to setting tax rates, Fitzgerald suggested that attention should also focus on sharing information that would allow, for example, countries to tax the assets of their own citizens held abroad. In addition to raising revenue, this would also be a disincentive to capital flight,because one of the major reasons for capital flight is tax avoidance.

2.4 Market Discipline and Government Policy

Kraay argued that good policies are likely to be the key factor contributing to increased investment flows.In the pro-CAL literature it is argued that liberalisation forces countries to adopt "good" policies because of market discipline, i.e. foreign investors will only invest in countries where inflation, budget deficits and balance of payments deficits are low, thus CAL encourages governments to maintain macroeconomic stability. However, the "discipline" imposed serves the interests of foreign and domestic investors not necessarily those of the poor.

In crisis situations market discipline, imposed by the markets or the IMF, has resulted in widespread social protests, for example, in Argentina, Turkey and Indonesia. Ironically, by worsening social conditions market confidence may actually worsen making it harder for the economy to recover.

Putting the objections to externally imposed policies and their social costs aside, does CAL lead to good policy? Arguing that governments should first finance expenditure from tax revenues, Sta. Ana, commented that CAL is a lazy policy. It allows governments to avoid other reforms which would be unpopular to elites but which could increase revenue collection from taxation. "The point is" remarked Sta. Ana, "a comprehensive tax reform agenda that makes the tax system buoyant, efficient and progressive reduces the temptation of governments to open up their capital accounts".

In addition Sta. Ana considered that "some of the so-called gains in economic fundamentals [attributed to market discipline] are illusory". He pointed out that "seemingly good [macroeconomic indicators] can mask uncertainty", i.e. low inflation is often achieved because of high interest rates, an overvalued currency and a stable exchange rate. In the short run investors take apparently rational decisions but when a crisis strikes these decisions look decidedly less rational.

Alternatively, Allen pointed out that to regain policy autonomy a government can either re-impose capital controls (as Malaysia did) or liberalise the exchange rate. With a growing shift to flexible exchange rates, market discipline will not be a significant issue. He points to Paul Krugman's model of the "Impossible Trinity" of maintaining, at the same time as a fixed exchange rate, an open capital account and domestic policy autonomy: "One of the lessons that we draw from the Mexican and Asian crisis and in Brazil, is that it's very difficult to maintain a fixed exchange rate, and so we have seen a generalised move to floating rates in these economies. This means that for most of these countries, we've given up a fixed exchange rate leaving us with capital market liberalisation and domestic policy autonomy. If that model is correct, it should be possible to accommodate more or less expansionary fiscal policy through the exchange rate movements, without touching the capital account liberalisation".

It remains to be seen whether this means that market discipline will be less important in the future. Intuitively, it seems likely that investors will always find negative aspects of economic policy to help ration their choices, in which case, market discipline is likely to continue to play an important role in investor decision-making.

Market Sentiment and Government Budgets

Market discipline or "sentiment" as Carvalho prefered, because this expresses the more "flimsy nature" and "obscure" actions of the market, has implications for government spending, in particular through restrictions on the budget deficit and negative reactions to progressive taxation proposals.

In general, foreign investors look for low budget deficits because this suggests low inflation which will protect their investment earnings. But as Sta. Ana questioned, who is it that has determined that a budget deficit of more than 4% is unsustainable? Granted in some cases this may be the case but in others it is not. It clearly depends on how the money is being spent and/or whether deficits signal a failure to take other actions for political reasons. A significant problem with market discipline is that all countries are treated the same; allowances are not made for individual country's circumstances.

Referring to Cobham's suggestion that market discipline may not be harmful if government spending is excessive and inefficient, although it might not encourage pro-poor spending, Sta. Ana remarked that even if cuts in spending may increase efficiency they are still likely to have a negative impact on the poor as health and education budgets are also cut.

A related issue,pointed out by Carvalho,is that governments are unlikely to be able to adopt progressive tax systems with liberalised capital accounts because market sentiment is likely to be adverse. Indeed,the signalling effects are likely to be much wider than the fiscal deficit.The market is also likely to be adverse to the introduction of laws such as the Community Investment Act in use in the USA to direct a proportion of new investment to poor communities. Indeed for poverty rooted in inequality a solution will require a restructuring of the economy in ways which are likely to be opposed by investors.

Market Confidence: Crisis Periods and Recovery

To restore investor confidence in a crisis period, the IMF has insisted on raising interest rates. Malhotra pointed out that the trade-off between monetary policy (high interest rates) and employment is substantial.Since employment is often the poor's only safetynet any action that reduces unemployment or underemployment will be significant for poverty reduction. However, most analysis has focussed on unemployment effects, overlooking the impacts of increased underemployment.

"The average person on the street in Bangkok at the time of the crisis was concerned about whether they would have a job, rather than how much higher inflation was anticipated through the policy response. So the monetary policy trade-off in this area was not appropriate,especially not in the early parts of the crisis",commented Malhotra. "The employment effects of interest rate policy responses and the way this impacted on small and medium enterprises, who are the largest employers of people in the real economy, was a very very serious effect."

Kraay noted that a World Bank paper[15] shows that hiking interest rates to very high levels to restore market confidence as a crisis emerges is not effective. Malhotra pointed out that in Thailand, confidence was not restored by high interest rates because investors were concerned with other factors in the economy.

Conclusions

This paper takes an initial look at some of the potential negative transition mechanisms between capital account liberalisation and poverty. It is necessary to understand these in order to identify appropriate systems, regulations and controls to address them in ways that empower and give opportunity to the poor.

The transition mechanisms identified in this paper can be distinguished between private i.e. impacts on family wealth, that is, employment, income, value of assets, ability to save and so on, and public, through impacts on government spending, in particular the provision of basic services, and taxation. These mechanisms are likely to have different impacts, or intensity of impact, depending on whether the economy is relatively stable or going through crisis. Also, they will have different impacts on different groups in society and amongst the poor. It is vital that these are studied further.

There will obviously be other mechanisms and these need also to be identified. Key areas for future research include:

- differentiating and monitoring flows by type to understand their impact through the economy, distinguishing between quantity and quality effects;
- understanding how flows impact on prices, such as exchange rates and interest rates and how important these are for the poor;
- understanding what are the effects on the formal versus the informal economy and the linkages between the two;
- understanding the impacts on the poor between those integrated into the market economy who can respond to market based mechanisms and those in the subsistence economy;
- identifying whether there are different impacts on the poor in countries which are more commodity market dependent;
- teasing out how the impacts of crises are transmitted from country to country and the impacts on different groups of the poor;
- understanding whether there are asymmetric impacts on different income/social groups;
- analysing the impacts of greater volatility and how aid policy can help to stabilise the macroeconomy;
- analysing to what extent market discipline will constrain pro-poor policy making;
- identifying regulations and policies which can help the poor to gain greater access to cheaper credit, to save and to benefit from domestic and international financial liberalisation;
- understanding the differences between poor countries compared with middle income countries.

As Kraay pointed out, the "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".

It was generally agreed that empirical, cross country models are not likely to yield useful information because whether CAL has indirect positive or negative impacts depends on the circumstances in each country. This makes the case for analysing the potential impacts on a "case by case" basis. The UK government's proposal for "road maps"[16] for financial reforms may be a helpful step forward to taking such an approach. However, they will not be helpful if the assumption is that the ultimate goal is capital account liberalisation. The goal should not be the tool, the goal is poverty reduction and CAL may or may not be part of the tool box that will help to achieve it.

But as Leape noted, "evidence-based policy requires evidence. Currently the available data is very poor, not only for those of us who are analysts or academics, but those who are policy makers in the countries themselves. This creates a very strong argument for building up this evidence, data collection and analytical capacity within countries should be a priority for donor support. There is also scope for NGOs to support creative initiatives in this area, ways we can get new kinds of information, household surveys etc which can bring to bear new linkages which we're undoubtedly not yet aware of in this area".

In terms of measuring and monitoring investment flows, Allen added that "if we are concerned about trying to understand the impact of liberalisation and the resulting capital flows on poverty, growth and other things, we really do need to know what is happening with capital flows and I think it is hard to underestimate how little we know about this,in particular with the developing countries,lower and middle income".

As Cobham concludes in his paper, whilst there is no clear evidence how CAL impacts on the poor, through the real economy, it suggests that the major powers, the G8 and the international institutions through which they assert themselves, should not codify such reforms or make them fundamental aims of international agreements, such as the General Agreement on Trade and Services or the IMF's articles of agreement. Neither should the IMF proceed with domestic and international liberalisation until it is clear what the objectives are in each case and how liberalisation will contribute to these, and it is able to assess the potential impacts.

Endnotes

1 This is a summary of the discussions at the Capital Account Liberalisation and Poverty meeting held in Oxford, 12th January 2001.The views expressed in this paper are those of the individuals and do not necessarily reflect those of the institutions they are associated with.See the end of this report for a list of participants.

2 In 1997 agreement was reached that the IMF should extend its Articles of Agreement to formalise its role in pursuing Capital Account Liberalisation in member countries.Like Article 8,which commits countries to current account liberalisation,member countries would be expected to proceed towards liberalising their financial sectors and capital accounts.Since the crises of the late 1990s, there has been much less talk of extending its mandate in such a formal way, however, it has been mooted by the Italian government which is hosting this year's G7 summit.

3 See for example, Jagdish Bhagwati, *The Capital Myth in Foreign Affairs,* May 1998

4 For example, see Barry Eichengreen et al, 1999, *Liberalizing Capital Movements, Some Analytical Issues,* Economic Issues 17, IMF,Washington DC,p13.

5 Flight capital is often regarded as a foreign flow.

6 For an analysis of how liberalisation has reduced growth generally see Eatwell and Taylor, 1999, *The Performance of Liberalised Capital Markets,* IPPR Working Paper; Danny Rodrik,1998, *Who Needs Capital-Account Convertibility?* Princeton Essay in International Finance.

7 Godfrey Kanyenze referred to the pressure to liberalise labour markets in the African context which he links to capital account liberalisation.In South Africa, there is increasing pressure for "investment friendly labour markets."

8 Charles Soludo and Musunuru Sam Rao, 2000, *Potential Social Impacts of the new Global Financial Architecture*. csoludo@infoweb.abs.net

9 Also see David Woodward,1998, *Drowning by Numbers:the World Bank, IMF and North South Financial Flows,* Bretton Woods Project,UK

10 See Peter Stalker, 2000, *Beyond Krismon, the Social Legacy of Indonesia's Financial Crisis,* UNICEF Innocenti Insight,Italy.

11 This may be the government's choice and not imposed by the IMF.

12 Malhotra pointed out that by the time the tight fiscal policy was loosened the damage to the economy and social sectors had already been done.

13 Peter Stalker, 2000.

14 Ibid

15 Aart Kraay, *Do High Interest Rates Defend Currencies Under Speculative Attack?*, draft 1999,World Bank.

16 DFID, *'Eliminating World Poverty:Making Globalisation Work for the Poor',* White Paper on International Development,December 2000

Capital Account Liberalisation and Poverty[1]

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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 – essentially 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

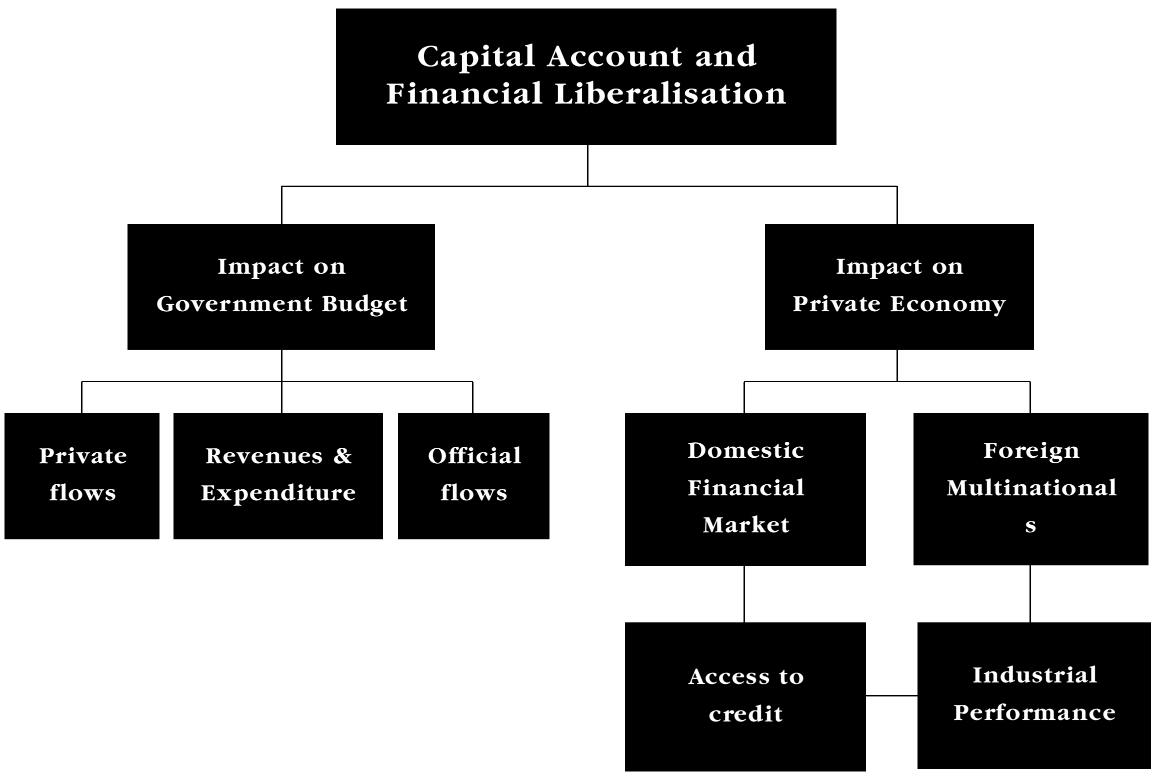
The key question in the current debate on capital account liberalisation and international financial integration is that of their impact on poverty. The problem for policymakers, both at the national level in developing countries and internationally for the multilateral institutions, is that the link 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 I 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,[2] 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.[3] 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

Types of Flow to Domestic Economy	Controls on Inflows	Controls on Outflows
Portfolio - equity	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).
bonds	Form:Restrictions on foreign holding (up to 100%). Intention:Reduce volatility.	As above.
Direct investment	Form:Investment boards Intention:Ensure integrity of national industry.	Forms:Profit repatriation restrictions,or reinvestment requirements. Intention:Ensure local economy benefits.
Bank lending	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 liberalisatin 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.

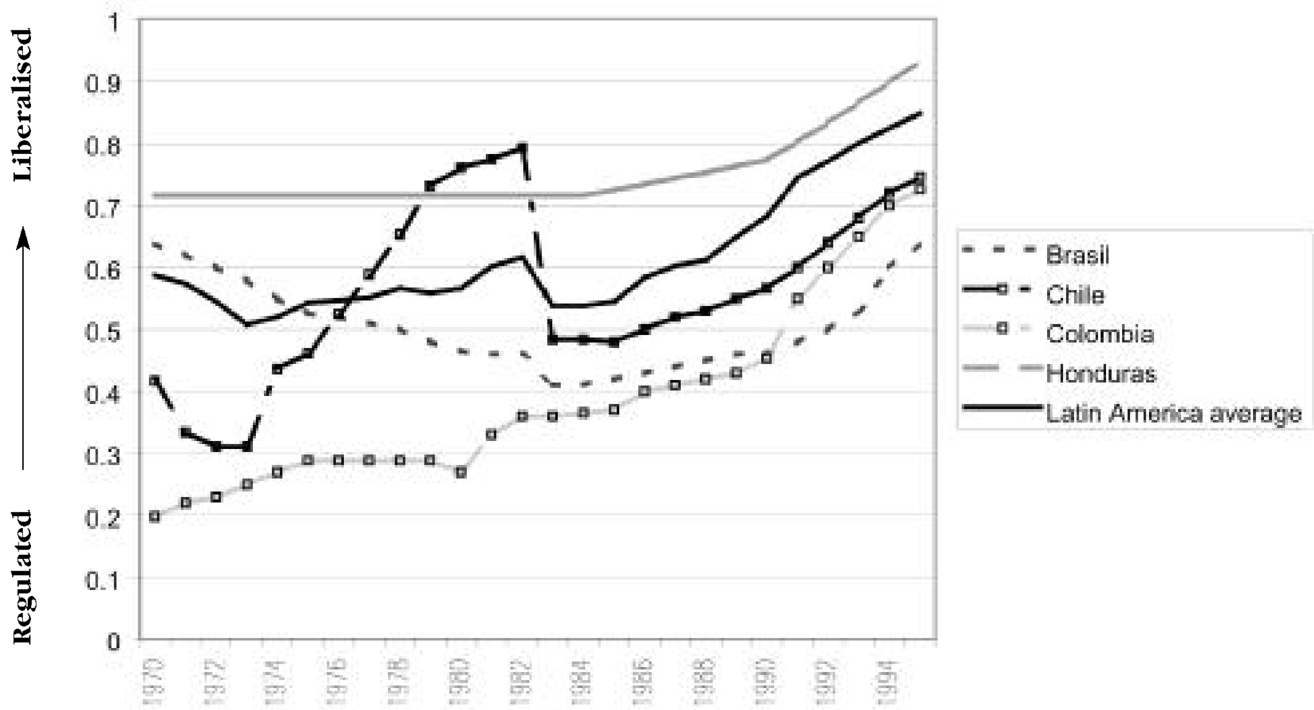
Third, a prerequisite for CAL to be successful is a greater degree of domestic financial libearlisation. Allowing foreign investment in domestic financial markets calls for minimum levels of both market efficiency and institutional and regulatory capacity to safeguard stability.These stem from two potentially 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.[4]

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.[5]

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, sould 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.[6] 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.[7] 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,[8] 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.[9] 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.[10]

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.[11] 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.[12] 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.[13] 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.[14] 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 healthcare 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 longstanding 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%.[15] 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.[16]

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.[17] 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.[18]

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.[19]

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 Programing 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 (reducing 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.[20]

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 underlying 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.[21] 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.[22]

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.[23]

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.[24]

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.[25] 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.[26] 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.[27]

Uncertainty impacts most strongly on the investments of smaller firms by causing them to be more volatile and hence less likely to be successful.[28] 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.[29]

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 positive: 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 information 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 vervus 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 ad 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.[30] 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 investment 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)

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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.

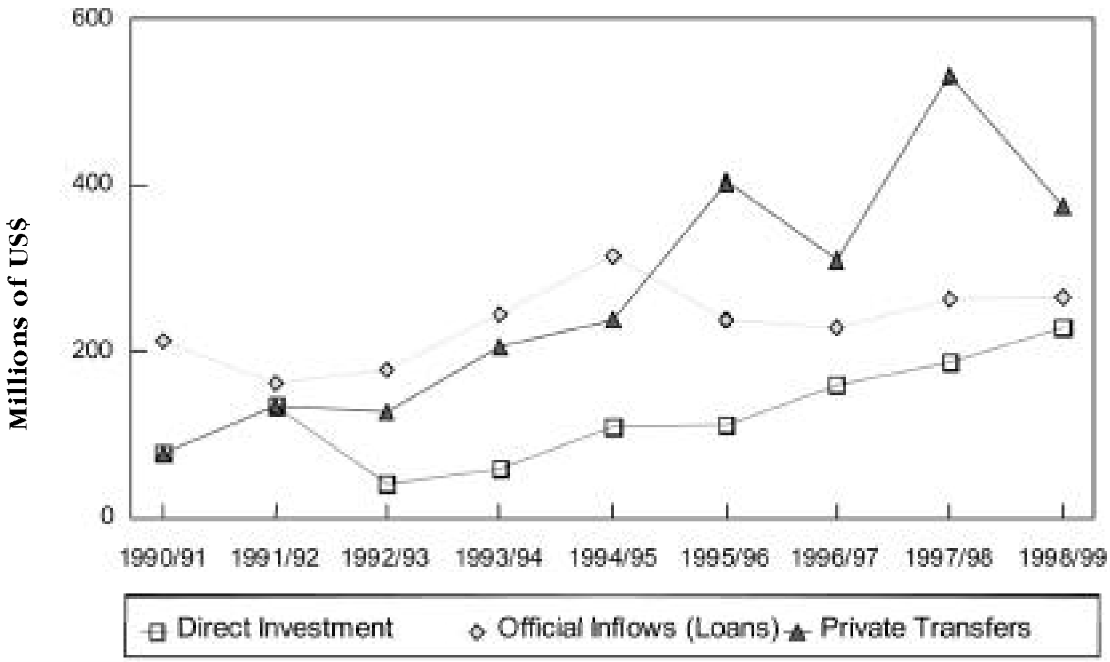
Another aspect, is whether or not the inflows are debt creating, and if so, is the current deficit they generate sustainable? My judgement is that non-debt-creating inflows are beneficial to any economy. Uganda attracts such flows in the form of workers remittances and FDI. If however, the flows are 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. macroeconomic 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 that capital account liberalisation matters for fiscal policy or is associated with higher inequality and poverty. But of course there are lots of caveats:

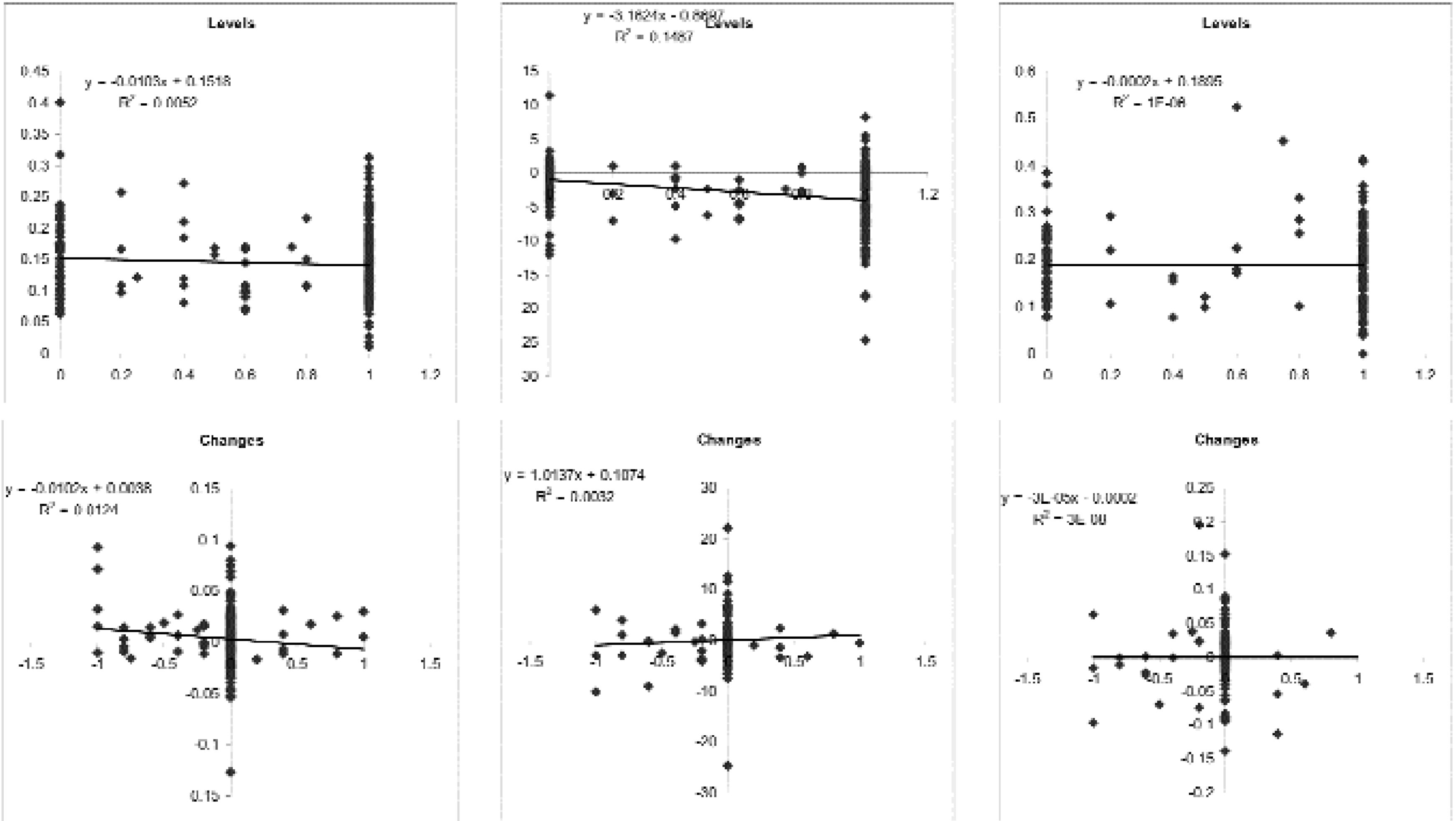
- Measurement is difficult, for capital controls (as discussed above) and especially poverty and inequality (where we are constrained by the limited availability of high-quality comparable household survey data). So can't rule out possibility that in all of this the data simply aren't informative *for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

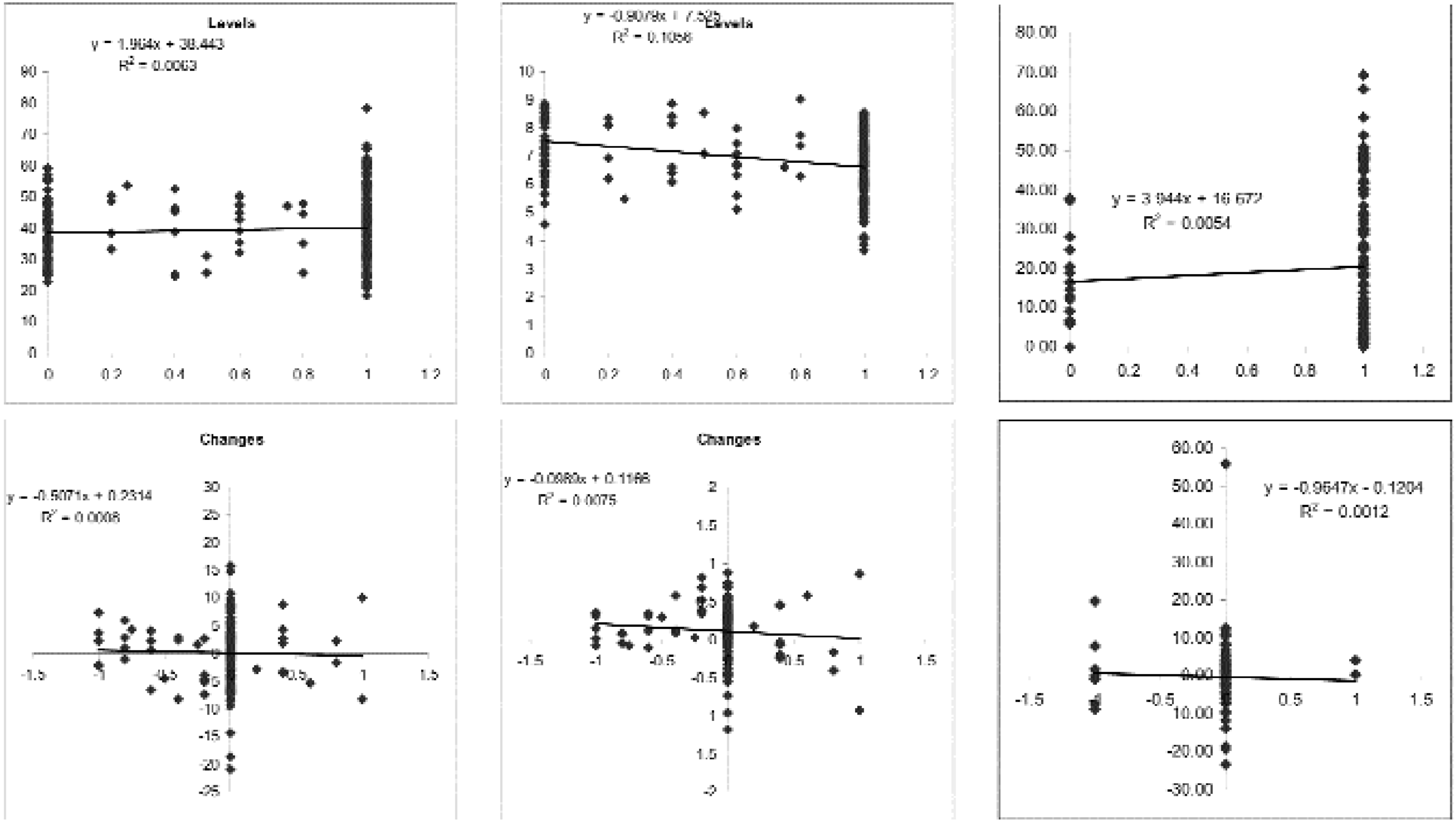
Gov't Cons/GDP **Fiscal Deficit/GDP** **Social Spending/Total Spending**



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 1999

2 Barry Eichengre *Capital Account Liberalisa What do country Studies Te* (mimeo. October 2 for *World Economic Review*) c Garrett an Mitchell.F also menti that Quin came up v opposite results.

3 See Barr Eichengre *Capital Controls: Capital Id Capital F* mimeo, Novembe 1998

Kamal Malhotra[1]
United Nations Development Programme

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.