The Economic and Social Effects of Financial Liberalization: A Primer for Developing Countries[1]

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For more than a decade now, financial liberalization in developing countries has been cited as a necessary and significant part of an economic policy package promoted by what used to be called the "Washington Consensus". Typically, financial sector liberalization in developing countries has been associated with measures that are designed to make the central bank more independent, relieve "financial repression" by freeing interest rates and allowing financial innovation, and reduce directed and subsidized credit, as well as allow greater freedom in terms of external flows of capital in various forms.

Increasingly, these policies are not imposed from outside, whether through the conditionality of multilateral lending institutions or bilateral pressure. Rather, policy makers, and especially those in finance ministries across the developing world, appear to have absorbed and internalized the idea that such measures are necessary to improve the functioning of the financial sector generally, in terms of profitability, competitiveness and intermediation, as well as to attract international capital to increase resources available for domestic investment. These ideas are usually supported by media, which caters to the elite in developing countries, to the extent that their constant reiteration also ensures that such measures have wide support among the elite and middle classes, who often have the most political voice in these countries.

Yet, the arguments in favour of financial liberalization – both theoretical and empirical – are relatively flimsy, and there are many grounds for scepticism regarding the claims made by the votaries of such measures. Indeed, there are good reasons for questioning both the extent and the pattern of the kind of financial liberalization that is promoted. In many cases, the social and economic effects have been especially adverse for the poor and for farmers and workers, who have not only suffered more precarious conditions even during a so-called "financial boom", but two have typically also been the worst affected during a financial crisis or the subsequent adjustment. It is also worth noting that the extreme forms of liberalization are neither effective nor necessary, and that a large variety of alternative measures, as well as varying degrees of liberalization, is not only possible but can also be observed in several more 'successful' developing countries.

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In this context, this paper examines various issues that are of immediate policy significance for developing countries. In the first section, the main elements of the standard pattern of financial liberalization that has become widely prevalent in developing countries are briefly described. In the second section, I consider the theoretical arguments for and against such measures. The third section contains a discussion of the political economy of such measures. The fourth section identifies the main economic and social effects of these measures, based on the actual experience of a number of emerging markets in the past one and a half decades. The final section draws some policy conclusions, and presents the case that a range of alternative strategies is still open to policy makers in developing countries.

The nature of financial liberalization

Financial liberalization refers to measures directed at diluting or dismantling regulatory control over the institutional structures, instruments and activities of agents in different segments of the financial sector. These measures can relate to internal or external regulations. (Chandrasekhar, 2004)

Internal financial liberalization typically includes some or all of the following measures, to varying degrees:

a) The reduction or removal of controls on the interest rates or rates of return charged by financial agents. Of course, the central bank continues to influence or administer that rate structure through adjustments of its discount rate and through its own open market operations. But deregulation typically removes interest rate ceilings and encourages competition between similarly placed financial firms aimed at attracting depositors on the one hand and enticing potential borrowers to take on debt on the other. As a result, price competition squeezes spreads and forces financial firms (including banks) to depend on volumes to ensure returns;

b) The withdrawal of the State from the activity of financial intermediation with the conversion of the "development banks" into regular banks and the privatization of the publicly owned banking system, on the grounds that their presence is not conducive to the dominance of market signals in the allocation of capital. This is usually accompanied by the decline of directed credit and the removal of requirements for special credit allocations to priority sectors, whether they be government, small-scale producers, agriculture or other sectors seen as priorities for strategic or developmental reasons;

c) The easing of conditions for the participation of both firms and investors in the stock market by diluting or doing away with listing conditions, by providing freedom in pricing of new issues, by permitting greater freedoms to intermediaries, such as brokers, and by relaxing conditions with regard to borrowing against shares and investing borrowed funds in the market;

d) The reduction in controls over the investments that can be undertaken by financial agents and, specifically, the breaking down the "Chinese wall" between banking and non-banking activities. Most regulated financial systems sought to keep separate the different segments of the financial sector such as banking, merchant banking, the mutual fund business and insurance. Agents in one segment were not permitted to invest in another for fear of conflicts of interest that could affect business practices adversely. The removal of the regulatory walls separating these sectors leads to the emergence of "universal banks" or financial supermarkets. This increases the interlinkages between and pyramiding of financial structures;

e) The expansion of the sources from and instruments through which firms or financial agents can access funds. This leads to the proliferation of instruments such as commercial paper and certificates of deposit issued in the domestic market and allows for offshore secondary market products such as ADRs (American Depository Receipts – the floating of primary issues in the United States market by firms not based in the United States) or GDRs (Global Depository Receipts);

f) The liberalization of the rules governing the kinds of financial instruments that can be issued and acquired in the system. This transforms the traditional role of the banking system's being the principal intermediary bearing risks in the system. Conventionally, banks accepted relatively small individual liabilities of short maturities that were highly liquid and involved lower income and capital risk and made large, relatively illiquid and risky investments of longer maturities. The protection afforded to the banking system and the strong regulatory constraints thereon were meant to protect its viability given the role it played. With liberalization, the focus shifts to that of generating financial assets that transfer risks to the portfolio of institutions willing to hold them;

g) The shift to a regime of voluntary adherence to statutory guidelines with regard to capital adequacy, accounting norms and related practices, with the central bank's role being limited to supervision and monitoring.

External financial liberalization typically involves changes in the exchange control regime. Typically, full convertibility for current-account transactions accompanying trade liberalization have been either prior or simultaneous reforms, which are then complemented with varying degrees of convertibility on the capital account. Capital-account liberalization measures broadly cover the following, in increasing degree of intensity, but with a wide variety of patterns of implementation:

a) Measures that allow foreign residents to hold domestic financial assets, either in the form of debt or equity. This can be associated with greater freedom for domestic firms to undertake external commercial borrowing, often without government guarantee or even supervision. It can also involve the dilution or removal of controls on the entry of new financial firms, subject to their meeting pre-specified norms with regard to capital investments. This does not necessarily increase competition, because it is usually associated with the freedom to acquire financial firms for domestic and foreign players and extends to permissions provided to foreign institutional investors, pension funds and hedge funds to invest in equity and debt markets, which often triggers a process of consolidation;

b) Measures which allow domestic residents to hold foreign financial assets. This is typically seen as a more drastic degree of liberalization, since it eases the possibility of capital flight by domestic residents in periods of crisis. However, a number of countries that receive "excessive" capital inflows that do not add to domestic investment in the net and are reflected in unnecessary accumulation of foreign-exchange reserves, have turned to such measures as a means of reducing pressure on the exchange rate;

c) Measures that allow foreign currency assets to be freely held and traded within the domestic economy (the "dollarization" of accounts). This is the most extreme form of external financial liberalization, which has been implemented only in very few countries.

The theoretical arguments for financial liberalization

Underlying most of the arguments for financial liberalization measures are some basic monetarist postulates, namely: (i) that real economic growth is determined by the available supply of factors of production such as capital and labour and the rate of productivity growth, and changes in money supply do not have any impact on real economic activity and the growth of output; (ii) that money supply is exogenous rather than endogenous to the system and can be controlled by the monetary authorities, who can successfully pursue well-defined targets for monetary growth, and (iii) that inflation is attributable to an excessive growth of money supply relative to an exogenously given "real rate of growth of output" and can be moderated by reducing the rate of growth of money supply. These postulates can then lead to arguments for an "independent" central bank whose essential job would be to control inflation by using money market levers to control money supply and therefore the price line.

The basic difficulty with these arguments is now rather well known. There is no clearly discernible relationship between the rates of growth of money supply and of inflation on the one hand and real output growth on the other. The monetarist argument is based on the twin assumptions of full employment (or exogenously given aggregate supply conditions) and aggregate money supply determined exogenously by macro-policy. Neither of these assumptions is valid; on the contrary, there is a strong case for arguing that, in a world of financial innovation where quasi-moneys can be created, the overall liquidity in the system cannot be rigidly controlled by the monetary authorities.

Rather, the actual liquidity in the system is endogenously determined. Therefore, the real monetary variable in the hands of the Government is the interest rate, and thus, attempts to control money supply typically end up as forms of interest rate policy instead. The notion of a stable "real demand for money" function (where the demand for money is determined by the level of real economic activity) is one which gets demolished by the possibility of speculative demand for money, a feature which, if anything, is enhanced by financial sophistication and the greater uncertainties operating in today's economies.

Further, though the package of policies described above has evolved over time, often in response to the demands of increasingly omnipresent and mobile international financial interests, its origins lie in the neoclassical notion of efficient financial markets. Capital markets are seen as being competitive and informationally efficient when they ensure the availability and full utilization of information required to determine the value of assets as well as to identify the best investments. These features ensure that the return that an investor expects to get from an investment would be equal to the opportunity cost of using the funds in some other project. To the extent that the structure of financial markets – the combination of institutions, instruments and agents – approximates this ideal, the system is seen as being able to mobilize the maximum savings for investment and allocate it most efficiently.

In addition, the need to eliminate financial repression (in the McKinnon-Shaw sense) has been provided as a powerful argument in favour of financial liberalization. Repressive policies are seen to be inimical to financial deepening, in the context of the observed empirical relationship between financial deepening and growth. Financial repression is said to have a depressive effect on savings rates and thereby to result in capital shortages and adversely affect growth. It is also argued that financial repression tends to selectively ration out riskier projects, irrespective of their social relevance, because interest rate ceilings imply that adequate risk premiums cannot be charged.

But there is, of course, a large theoretical literature pointing out that financial markets inherently cannot be as perfect as this and, indeed, are structurally more imperfect than the markets for goods. Since information as a commodity has strong public good characteristics (non-rivalry in consumption and non-excludability in provision), this typically results in the inadequate acquisition of information even in apparently "competitive" markets. In financial markets this means that those who manage investments are, therefore, inadequately monitored, which encourages inappropriate risk-taking or even fraud that could lead to insolvency. There are many examples of market failure in financial markets resulting from asymmetric information, adverse selection, incentive-incompatibility and moral hazard, which are then aggravated because of further imperfections and the inter-linkages between financial agents.[2] These are, of course, in addition to the other more standard forms of imperfection in markets resulting, for example, from imperfect competition, oligopolies and increasing returns.

There are other problems that result because social returns differ from private returns. Projects with high social returns may not be the ones that deliver the highest profits to the bank or financial investor. Banks may be willing to increase their exposure to "sensitive sectors" like the stock and real estate markets, given the higher interest that clients are willing to pay on the expectation of larger speculative profits. Besides exposing banks to the dangers of a stock or real estate market collapse, such options reduce lending to investors in manufacturing or the agricultural sector who cannot accept extremely high interest rates. This was one of the principal reasons why Governments sought to create public sector banks and direct public and private credit to socially important sectors.

[2] The implications of these theoretical points have been usefully summarized in Stiglitz (1993).

Likewise, there are reasons to question the arguments about financial repression. There are reasons to believe that financial deepening (measured by the ratio of financial to real wealth) and increased financial intermediation (measured by the share of financial assets of financial institutions in total financial assets) need not be, in themselves, stimuli to growth, despite myriad efforts to prove that this is true. The existence of usurious money lending in backward agriculture, which limits rather than promotes growth, is indicative of the fact that inequality of a kind inimical to growth influences the nature of a financial structure. Also, evidence suggests that financial crises are inevitably preceded by a phase of financial deepening and increased intermediation.

Further, the implicit view that savings are automatically reinvested and that any increase in savings leads automatically to an increase in investment is a pre-Keynesian argument with little relevance to demand-constrained economies with unutilized resources. Empirical studies of savings have shown that there is little relationship between national savings and real interest rates. Similarly, the developmental or social role of banking is especially relevant when lowering interest rates can increase the quality of borrowers, and it can have substantial beneficial effects if the Government is able to select the better projects and recipients of finance.

The political economy of financial liberalization

The current role of international finance is critically related to the manner in which finance capital rose to a position of dominance in the global economy and to the role that cross-border flows of capital have been playing in the process of globalization. High rates of cross-border capital flows were evident during the late nineteenth and early twentieth centuries. In the inter-war period, these capital movements became dominantly speculative in nature and were associated with very high volatility in currency markets, even among the industrial countries of the time. It was precisely this experience of currency instability and competitive devaluation that provided the impetus for the establishment of the Bretton Woods system, which was based on fixed exchange rates and stringent capital controls for the first two and a half decades.

The major industrial capitalist countries first began relaxing controls on currency movements in the late 1960s, and the move to "floating" or flexible exchange rates in the 1970s hastened the process. In that decade, there were specific developments outside the realm of finance itself that contributed to an increase in international liquidity, such as the surpluses generated by oil exporters after the oil price increases, which were largely deposited with the international banking system. This was reflected in the explosion of the Eurocurrency market in the 1970s.

From the 1980s, there were other real factors that created pressures for the expansion of finance. These included the changing demographic structure in most of the advanced countries, with baby boomers reaching an age where they were emphasizing personal savings for retirement. This was accentuated by changes in the institutional structures relating to pensions, whereby in most industrial countries, public and private employers tended to fund less of the planned income after retirement, requiring more savings input from employees themselves. All this meant growing demands for more variety in the form of savings as well as higher returns, leading to the greater significance of pension funds, mutual funds and the like.

Financial liberalization in the developed countries was closely related to these developments. However, it also contributed to the generation of savings which were in excess of investment ex ante. Financial liberalization in the developed countries increased the flexibility of banking and financial institutions when creating credit and making investments, and permitted the proliferation of institutions like hedge funds which, unlike the banks, were not subject to much regulation. It also encouraged "securitization", or capital flows in the form of stocks and bonds, rather than loans, and "financial innovation", involving the creation of a range of new financial instruments or derivatives such as swaps, options and futures, virtually autonomously created by the financial system. These instruments allowed players to trade in the risks associated with an asset without trading the asset itself. Finally, it increased competition and whetted the appetite of banks to earn higher returns, thus causing them to search out new recipients for loans and investments in economic regions that were hitherto considered to be too risky.

Financial liberalization began with versions of the "big bang" in developed country markets. This was because, by the late 1960s, it became clear that old-style Keynesian policies were increasingly incapable of dealing with the secular deceleration that threatened most developed countries, especially the United States. Further, with a weakening United States economy leading to the breakdown of the Bretton Woods arrangement and the emergence of a world of floating exchange rates, pursuing Keynesian-style policies in any one country threatened a collapse of the currency. Any effort to pump-prime the system generated inflation, rendered domestic goods less competitive in world markets, widened the trade deficit and weakened the currency. The collapse of old-fashioned Keynesianism was therefore also related to the fact that it was based on the assumption of a particular type of nation State, which was no longer valid. In consequence, some other means of trying to spur growth was required, and this role was played by the easy availability of liquidity in the "international" banking system based in the developed countries.

There followed a massive increase in international liquidity, as banks and non-bank financial institutions desperately searched for means to keep their capital moving, since that had become the route to higher profits in the financial sector. There were booms in consumer credit and housing finance in the developed industrial nations. However, when those opportunities petered out, a number of developing countries were discovered as the "emerging markets" of the global financial order. Capital -- in the form of debt and equity investments -- began to flow into these countries, especially those that were quick to liberalize rules relating to cross-border capital flows and regulations governing the conversion of domestic into foreign currency. As a result of these developments, there was a host of new financial assets in emerging markets characterized by higher interest rates, ostensibly because of greater investment risks in these areas. The greater 'perceived risk' and higher returns associated with financial instruments in these countries provided the basis for a whole range of new derivatives that bundled these risks and offered hedges against risk in different markets, each of which promised high returns.

There are a number of features characteristic of the global financial system that have evolved in this manner. One of the most important of current significance is the growing importance of unregulated financial agents, such as the so-called hedge funds, in the system. Although hedge funds first originated immediately after the Second World War, they have grown in number and financial strength in recent times. Their investors include major international banks, which are themselves forced by rules and regulations to avoid risky transactions promising high returns, but which use the hedge funds as a front to undertake such transactions. More recently, even mutual funds and pension funds have been attracted to hedge funds because of the higher returns promised, and this is currently the fastest growing segment of the international financial sector.

Second, the current global financial system is obviously characterized by a high degree of centralization. With United States financial institutions intermediating global capital flows, the investment decisions of a few individuals in a few institutions virtually determine the nature of the "exposure" of the global financial system. Unfortunately, unregulated entities making huge profits on highly speculative investments are at the core of that system.

Further, once institutions that are free of the now-diluted regulatory system exist, even those that are more regulated become entangled in risky operations. They are entangled because they themselves have lent large sums in order to benefit from the promise of larger returns from the risky investments undertaken by the unregulated institutions. They are also entangled because the securities on which these institutions bet in a speculative manner are also securities that these banks hold as "safe investments". If changes in the environment force these funds to dump some of their holdings to clear claims that are made on them, the prices of securities the banks directly hold tend to fall, thus affecting their assets position adversely.

Entanglement takes other forms as well. With financial firms betting on interest rate differentials and exchange-rate changes at virtually the same time, the various asset markets relating to debt, securities and currency are increasingly integrated. Crises, when they occur, do not remain confined to one of these markets but quickly spread to others, unless stalled by government intervention. Finally, the rise of finance in the manner described above feeds on itself in complex ways.

This means that there are two major consequences of the new financial scenario: it is difficult to judge the actual volume and risk of the exposure of individual financial institutions; and within the financial world, there is a complex web of entanglement, where all firms are mutually exposed, but where each individual firm is exposed to differing degrees to particular financial entities. It also makes a mockery of prudential norms, such as "capital adequacy" ratios, which have supposedly become more strict over time, since it becomes difficult to actually define or measure the extent of capital once such pyramiding of assets is widely prevalent.

Further, the process of financial consolidation on this base has substantially increased the risks associated with the system. During the 1990s, the three-decade-long process of proliferation and rise to dominance of finance in the global economy reached a new phase. The international financial system was being transformed in ways that were substantially increasing systemic risk and rendering the system more crisis-prone. Central to this transformation was growing financial consolidation. This has concentrated financial activity and decision-making in a few economic organizations and also integrated areas of financial activity earlier separated from one another to ensure transparency and discourage unsound financial practices.

The proximate explanation for the wave of financial liberalization in the developing countries is that this pyramidal growth of finance, which increased the fragility of the system, was seen as an opportunity. Enhanced flows to developing countries, initially in the form of debt and subsequently in the form of debt and portfolio investments, led to two consequences. First, the notion of external vulnerability which underlay the interventionist strategies of the 1950s and 1960s no longer seemed relevant – after all, any current-account deficit could be financed, it appeared, as long as such capital inflows were assured. Second, growth was now easier to ensure without having to confront domestic vested interests, since international liquidity could be used not merely to finance current and capital expenditures but also to ease any supply-side constraints that would otherwise hamper such growth.

Until quite recently, the financial press, the international financial institutions and large sections of the academic community were uninhibitedly in favour of these tendencies. It was argued that this created an opportunity for developing countries to launch on an integrationist growth strategy, since in any case, the sums they required were seen as a small fraction of the international liquidity being created by the financial system. For western finance, emerging markets were a hedge, and for developing countries, international finance was an opportunity. A cosy relationship seemed easy to build. It appeared that all that was needed was the liberalization of finance and a monetary policy that ensured interest rates high enough to make capital inflows attractive, even after adjusting for risk.

Trade and financial liberalization in developing countries would not have been sustainable, even for short periods, had it not been for the availability of fluid finance from the financial centres of the world economy. The availability of such finance reflected the rise to dominance of finance capital in the global economy, reforms protecting and privileging its interests and the consequent role that cross-border flows of capital played in the process of globalization. It also reflected the emergence of a "financial class" within many developing countries, which became a major lobby promoting the interests of international finance in general with respect to both financial liberalization and domestic macroeconomic policies.

This virtual financial explosion in developing country markets is largely explained by the factors encouraging financial capital to move out of the developed countries. First, emerging financial markets, though volatile, offer extremely high returns in a period when the debt overhang and slow growth in the developed countries has affected financial interests adversely. That makes risk-discounted returns in the developing countries much better than in the developed. Second, privatization programs have put up for sale resources of substantial value that can be acquired relatively cheaply in a context of currency depreciation. Third, these are markets in which the pent-up demand for credit is substantial and where innovative financial instruments have not been experimented with in the past. And finally, real interest rates, and therefore financial sector returns, tend to be relatively high in developing countries undertaking adjustment programs involving monetary stringency.

The combination of debt and portfolio capital has meant that for the last three decades, at least the more developed among the developing countries have found it much easier – except, of course, when crisis strikes – to access private foreign capital flows. This is taken to imply that the rise to dominance of finance and its globalizing influence has rendered the current-account deficit in many developing countries less of a binding constraint.

But the boom obviously could not be consistent in all emerging markets. First, it became clear that none of these borrowers were in a position to meet their debt-service payments without resorting to further borrowing. This, together with the evidence of the colossal overexposure of the international banking system in many developing countries, set afoot the deceleration in the flow of liquidity that came to be called the ‘debt crisis’. The banks, of course, could not pull out completely, because that would have spelt closure for many of them, as much of developing country debt would have had to be written off rather than rescheduled.

But the problem went deeper, since with the rise to dominance of finance capital relative to industrial capital in the developed nations, the financial system was awash with liquidity, but creditworthy borrowers were difficult to come by in an increasingly recessionary environment. In the event, debt was replaced with other kinds of non-debt private capital flows. Here too, however, the evidence suggests that, barring rare exceptions, periods of accelerated capital flow were followed by inevitable financial crises, when foreign investors turned wary and chose to withdraw their investments.

It is interesting to note that the enthusiasm for financial liberalization, especially of capital account transactions, appears to be unabated among developing country policy makers, despite all the evidence of greater frequency and intensity of crises in emerging markets. Indeed, the acceptance of capital-account liberalization continues, even though research from very mainstream quarters, including the International Monetary Fund (IMF), increasingly suggests that financial liberalization plays little role in increasing the investment rates of developing countries and exposes countries to many undesirable risks of volatility, deflation and crisis.[3]

[3] See, for example, Prasad and others (2003), Feldstein (ed.) (2003).

In many countries, financial reforms are seen, even now, as the most essential and urgent of the "second-generation reforms" that typically follow upon the "first-generation reforms" such as trade liberalization, privatization of a range of public activities and internal deregulation of various markets. It is also clearly the case that the pressures for financial liberalization do not come only from external agencies; rather, there are internal pressures generating from the economic requirements of domestic capital, the interests of local elites and the emergence of domestic "financial classes" as described above.

The negative effects of financial liberalization

There are some significant negative economic and social effects of financial liberalization, which are often so large that they significantly outweigh any benefits in terms of access to more capital inflows. These relate both to financial markets and to the real economy. Essentially, financial liberalization creates exposure to the following kinds of risk: a propensity to financial crises, both external and internal; a deflationary impact on real economic activity and reduced access to funds for small-scale producers, both urban and rural. This in turn has major social effects in terms of loss of employment and more volatile material conditions for most citizens.

Financial fragility and the propensity to crisis

It is now widely accepted that financial liberalization has resulted in an increase in financial fragility in developing countries, making them prone to periodic financial and currency crises. These relate both to internal banking and related crises, and currency crises stemming from more open capital accounts. The origin of several crises can be traced to the shift to a more liberal and open financial regime, since this unleashes a dynamic that pushes the financial system towards a poorly regulated, oligopolistic structure, with a corresponding increase in fragility. Greater freedom to invest, including in sensitive sectors such as real estate and stock markets, ability to increase exposure to particular sectors and individual clients and increased regulatory forbearance all lead to increased instances of financial failure. In addition, as mentioned earlier, the emergence of universal banks or financial supermarkets increases both the degree of entanglement of different agents within the financial system and the domino effects of individual financial failures.

Financial markets, left to themselves, are known to be prone to failure because of the public goods characteristics of information which agents must acquire and process. They are characterized by insufficient monitoring by market participants. Individual shareholders tend to refrain from investing money and time in acquiring information about management hoping that others will do so instead and knowing that all shareholders, including themselves, benefit from the information garnered. As a result, there may be inadequate monitoring leading to risky decisions and malpractice. Financial firms wanting to reduce or avoid monitoring costs may just follow other, possibly larger, financial firms in making their investments, leading to what has been observed as the "herd instinct" characteristic of financial players. This not merely limits access to finance for some agents, but could lead to overlending to some entities, the failure of which could have systemic effects. The prevalence of informational externalities can create other problems. Malpractice in a particular bank leading to failure may trigger fears among depositors in other banks, resulting in a run on deposits there.

Disruptions may also occur because expected private returns differ from social returns in many activities. This could result in a situation where the market undertakes unnecessary risks in search of high returns. Typical examples are lending for investments in stocks or real estate. Loans to these sectors can be at extremely high interest rates because the returns in these sectors are extremely volatile and can touch extremely high levels. Since banks accept real estate or securities as collateral, borrowing to finance speculative investments in stock or real estate can spiral. This type of activity thrives because of the belief that losses, if any, can be transferred to the lender through default, and lenders are confident of government support in case of a crisis. This could feed a speculative spiral that can in time lead to a collapse of the bubble and bank failures.

Meanwhile, all too often the expected microeconomic efficiency gains are not realized. Even in the United States, bond markets play a limited role and equity markets virtually no role at all in financing corporate investment in these countries. The stock market is primarily a site to exchange risks rather than raise capital for investment. In developing countries, too, the new issues market is small or non-existent except in periods of a speculative boom, and bank lending post-liberalization privileges risky high-return investment rather than investment in the commodity-producing sectors like manufacturing and agriculture. The effects on those sectors of liberalization are indirect, as they are realized through the demand-generating effects of housing and personal finance booms, which in many circumstances also tend to increase the fragility of the system.

Another result of financial liberalization in imperfect markets is the strengthening of oligopolistic power through the association of financial intermediaries and non-financial corporations. Financial intermediaries that are a part of these conglomerates allocate credit in favour of companies belonging to the group; this is by no means a more efficient means of allocation than could have occurred under directed-credit policies of the Government.

Moreover, while financial liberalization does encourage new kinds of financial savings, total domestic savings typically do not increase in many cases, and expansion of available financial savings is often the result of and inflow of foreign capital. With deposits and loans of less than six months' duration dominating, liberalization does not necessarily result in intermediation of financial assets with long-term maturities either. And despite short booms in stock markets, there tends to be relatively little mobilization of new capital or capital for new ventures. In fact, small investors tend to withdraw from markets because of allegations of manipulation and fraud, and erstwhile areas of long-term investments supported by State intervention tend to disappear. Not surprisingly, investment performance does not usually reflect signs of improved volume or more efficient allocation either.

External financial liberalization, with associated capital inflows, only aggravates these consequences. Indeed, all the evidence on capital inflows and subsequent crises suggests that once an emerging market is "chosen" by financial markets as an attractive destination, processes are set in motion which are eventually likely to culminate in crisis. This works through the effects of a surge of capital inflows on exchange rates (unless the capital does not add to an increase in domestic investment but simply ends up adding to reserves).

An appreciating real exchange rate encourages investment in non-tradable sectors, the most obvious being real estate, and in domestic asset markets generally. At the same time, the upward movement of the currency discourages investment in tradables and therefore contributes to a process of relative decline in real economic sectors, and even deindustrialization in developing countries. Given the differential in interest rates between domestic and international markets and the lack of any prudence on the part of international lenders and investors, local agents borrow heavily abroad to directly or indirectly invest in the property and stock markets.

Thus, it was no accident that all of the emerging market economies experiencing substantial financial capital inflows also experienced property and real estate booms, as well as stock market booms, around the same time, even while the real economy may have been stagnating or even declining. These booms, in turn, generated the incomes to keep domestic demand and growth in certain sectors growing at relatively high rates. This soon resulted in signs of macroeconomic imbalance, not in the form of rising government fiscal deficits, but as a current-account deficit reflecting the consequences of debt-financed private profligacy.

However, once there is growing exposure in the form of a substantial presence of internationally mobile finance capital, any factor that spells an economic setback, however small or transient, can trigger an outflow of capital as well. And the current-account deficits that are necessarily associated with capital-account surpluses (unless there is large reserve accumulation) eventually create a pattern whereby the trend becomes perceived as an unsustainable one, in which any factor, even the most minor or apparently irrelevant one, can trigger a crisis of sudden outflows.

One very common conclusion that has been constantly repeated since the start of the Asian crisis in mid-1997 is the importance of "sound" macroeconomic policies once financial flows have been liberalized. It has been suggested that many emerging markets have faced problems because they allowed their current-account deficits to become too large, reflecting too great an excess of private domestic investment over private savings. This belated realization is a change from the earlier obsession with government fiscal deficits as the only macroeconomic imbalance worth caring about, but it still misses the basic point.

This point is that, with completely unbridled capital flows, it is no longer possible for a country to control the amount of capital inflow or outflow, and both movements can create consequences which are undesirable. If, for example, a country is suddenly chosen as a preferred site for foreign portfolio investment, it can lead to huge inflows which in turn cause the currency to appreciate, thus encouraging investment in non-tradables rather than tradables, and altering domestic relative prices and, therefore, incentives. Simultaneously, unless the inflows of capital are simply (and wastefully) stored up in the form of accumulated foreign-exchange reserves, they must necessarily be associated with current-account deficits.

Large current deficits are therefore necessary by-products of the surge in capital inflow, and that is the basic macroeconomic problem. This means that any country which does not exercise some sort of control or moderation over private capital inflows can be subject to very similar pressures. These then create the conditions for their own eventual reversal, when the current-account deficits are suddenly perceived to be too large or unsustainable. In other words, what all this means is that, once there are completely free capital flows and completely open access to external borrowing by private domestic agents, there can be no "prudent" macroeconomic policy; the overall domestic balances or imbalances will change according to the behaviour of capital flows, which will themselves respond to the economic dynamics that they have set into motion.

This points to the futility of believing that capital-account convertibility accompanied by domestic prudential regulation will ensure against such boom-bust volatility in capital markets. With completely unbridled capital flows, it is no longer possible for a country to control the amount of capital inflow or outflow, and both movements can create consequences that are undesirable. Financial liberalization and the behaviour of fluid finance have therefore created a new problem which is analogous to the old "Dutch disease", with capital inflows causing an appreciation of the real exchange rate that causes changes in the real economy and therefore generates a process that is inherently unsustainable over time.

Deflation and developmental effects

The most forceful critique of financial liberalization relates not only to the enhanced possibility of crises, but to the argument that it has a clear bias towards deflationary macroeconomic policies and forces the State to adopt a deflationary stance to appease financial interests. (Patnaik, 2003) To begin with, the need to attract internationally mobile capital means that there are limits to the possibilities of enhancing taxation, especially on capital. Typically, prior or simultaneous trade liberalization has already reduced the indirect tax revenues of States undertaking financial liberalization, and so tax-GDP ratios often deteriorate in the wake of such liberalization. This then imposes limits on government spending, since finance capital is generally opposed to large fiscal deficits. This not only affects the possibilities for countercyclical macroeconomic stances of the State but also reduces the developmental or growth-oriented activities of the Government.

Financial interests are against deficit-financed spending by the State for a number of reasons. To start with, deficit financing is seen to increase the liquidity overhang in the system, and is therefore viewed as being potentially inflationary. Inflation is anathema to finance since it erodes the real value of financial assets. Second, since government spending is “autonomous” in character, the use of debt to finance such autonomous spending is seen as introducing into financial markets an arbitrary player not driven by the profit motive, whose activities can render interest rate differentials that determine financial profits more unpredictable. If deficit spending leads to a substantial build-up of the State’s debt and interest burden, it is possible that the Government may intervene in financial markets to lower interest rates with implications for financial returns. Financial interests wanting to guard against that possibility tend to oppose deficit spending. Finally, since financial interests privilege the role of markets, the presence of the State as regulator and the interventionist activity of the State can be seen as de-legitimizing the role of finance, which is another reason why financial markets tend to prefer the reduction and control of government deficits.

These tendencies affect real investment in two ways. First, if speculative bubbles lead to financial crises, they squeeze liquidity and increase costs for current transactions and result in distress sales of assets and deflation that adversely impact on employment and living standards. Second, inasmuch as the maximum returns to productive investment in agriculture and manufacturing are limited, there is a limit to what borrowers would be willing to pay to finance such investment. Thus, despite the fact that social returns to agricultural and manufacturing investment are higher than those for stocks and real estate, and despite the contribution that such investment can make to growth and poverty alleviation, credit at the required rate may not be available.

This is why it is increasingly recognized that liberalization can dismantle the very financial structures that are crucial for economic growth. While the relationship between financial structure, financial growth and overall economic development is complex, the basic issue of financing for development is really a question of mobilizing or creating real resources. In the old development literature, finance in the sense of money or financial assets came into play only when looking at the ability of the State to tax away a part of the surplus to finance its development expenditures, and at the obstacles to deficit-financed spending, given the possible inflationary consequences if real constraints to growth were not overcome. By and large, the financial sector was seen as adjusting to the requirements of the real sector.

In the brave new world, however, when the financial sector is increasingly left unregulated or covered by a minimum of regulation, market signals determine the allocation of investible resources and therefore the demand for and the allocation of savings intermediated by financial enterprises. This can result in the problems conventionally associated with a situation where private rather than overall social returns determine the allocation of savings and investment. It aggravates the inherent tendency in markets to direct credit to non-priority and import-intensive but more profitable sectors, to concentrate investible funds in the hands of a few large players and to direct savings to already well-developed centres of economic activity.

The socially desirable role of financial intermediation therefore becomes muted. This certainly affects employment-intensive sectors such as agriculture and small-scale enterprises, where the transaction costs of lending tend to be high, the risks many and collateral not easy to ensure. The agrarian crisis in most parts of the developing world is at least partly, and often substantially, related to the decline in the access of peasant farmers to institutional finance, which is the direct result of financial liberalization. Measures which have reduced directed credit towards farmers and small producers have contributed to rising costs, greater difficulty of accessing necessary working capital for cultivation and other activities, and have reduced the economic viability of cultivation, thereby adding directly to rural distress. In India, for example, there is strong evidence that the deep crisis of the cultivating community, which has been associated with a proliferation of farmers' suicides and other evidence of distress such as mass migrations and even hunger deaths in different parts of rural India, has been related to the decline of institutional credit, which has forced farmers to turn to private moneylenders and involved them once more in interlinked transactions to their substantial detriment.

It also has a negative impact on any medium-term strategy for ensuring growth in particular sectors through directed credit, which had been the basis for the industrialization process through much of the twentieth century. In the past, in a large number of developing countries, the financial structure had been developed keeping in mind its developmental instrumentality. Financial structures were therefore created to deal with the difficulties associated with late industrial entry: capital requirements for entry in most areas were high, because technology for factory production had evolved in a capital-intensive direction from its primitive industrial revolution level; competition from established producers meant that firms had to concentrate on production for a protected domestic market or be supported with finance to survive long periods of low-capacity utilization during which they could find themselves a foothold in world markets.

Not surprisingly, therefore, most late industrializing countries created strongly regulated and even predominantly State-controlled financial markets aimed at mobilizing savings and using the intermediary function to influence the size and structure of investment. This they did through directed credit policies and differential interest rates, and the provision of investment support to the nascent industrial class in the form of equity, credit and low interest rates.

By dismantling these structures, financial liberalization destroys an important instrument that historically evolved in late industrializers to deal with the difficulties of ensuring growth through the diversification of production structures that international inequality generates. This implies that financial liberalization is likely to have depressing effects on growth through means other than just the deflationary bias it introduces into countries opting for such liberalization.

This is all the more significant because the process of financial liberalization across the globe has not generated greater net flows of capital into the developing world, as was expected by its proponents. Rather, for the past several years, the net outflows have been in the reverse direction. Even the emerging markets, which have been substantial recipients of capital inflows, have not experienced increases in aggregate investment rates as a consequence, but have built up their external reserves. This is only partly because of precautionary measures to guard against possible financial crises; it also indicates a macroeconomic situation of ex ante excess of savings over investment resulting from a deflationary macroeconomic stance. For example, East and South Asia together received US$186 billion of capital inflows in 2003, but added to their foreign-exchange reserves to the tune of US$245 billion in the same year!

The curious workings of international financial markets have contributed to international concentration, whereby developing countries (particularly those in Asia) hold their reserves in US Treasury bills and other safe securities, and thus contribute to the fact that the United States economy currently absorbs more than two thirds of the world's savings. At the same time, developing countries are losing in financial terms because of the costs of holding these reserves since, typically, the reserves are invested in very low-yielding "safe" assets while capital inflows include debt-creating flows at much higher rates of interest. This inverse and undesirable form of financial intermediation is, in fact, a direct result of the financial liberalization measures that have simultaneously created deflationary impulses and increased financial fragility across the developing world.

Alternative strategies for developing country financial systems

It is evident from this discussion that complete financial liberalization – in the sense of implementing *all* of the various internal and external measures described here, is neither necessary nor desirable. In fact, such extreme measures have not been implemented by the more successful developing country industrializers. In fact, the examples of those countries that have successfully industrialized – from the nineteenth century onwards, and continuing to date – is instructive, because there are two features which are common to all of them: some degree (usually substantial) of directed credit; and some controls on cross-border capital flows.

The role played by directed credit in countries like Japan and the South Korea is well known, but it was in fact also a crucial element of the industrialization strategy in nineteenth-century Germany and in the early twentieth-century United States, among others.[4] Control over the allocation of bank credit continues to be one of the most significant ways in which the Chinese Government is able to control both the level and distribution of economic activity in the ongoing phase of rapid economic growth.

Similarly, capital controls of various sorts have been very important in allowing the economic space required for industrializing countries to influence domestic investment and reduce unintended volatility in markets. It is true that trade controls and the encouragement of a degree of import substitution has also been very necessary for late industrializers, and that too is something which is much more possible and likely when the capital account is also controlled.

The typical response to this among policy makers is that all this may be historically true, but the world has changed and such strategies are no longer possible because the forces of globalization and the new international regimes have dramatically

[4] Summary accounts of these experiences are provided in Reinert (ed.) (2004) and Chang (2002).

restricted the scope for autonomous national policies. The most common argument today is that developing countries simply have no choice but to follow the path of greater external economic integration and financial liberalization.

However, this is not really true, as is evident even from the actual practices being followed in different parts of the developing world, which do not get adequate publicity. In particular, with respect to the capital account of the balance of payments, there is a wide range of possibilities and methods of regulation or direction of capital flows. There is already a large set of controls which have been used quite recently (and continue to be used in some countries) which provide good examples.[5] Capital controls of varying sorts have been used to effect in recent times by countries ranging from Chile and Colombia to Taiwan Province of China and Singapore.

There are the more obvious direct controls which regulate the actual volume of inflow or outflow in quantitative terms. These can relate to foreign direct investment (FDI) and to external borrowing by residents as well as to portfolio capital flows. In addition, these can be directed within the economy towards particular sectors or recipients through positive or negative lists. But there are also more indirect or market-based methods which have been increasingly used to regulate capital movements. Several countries have specified a minimum residence requirement (of one to three years) on portfolio capital inflows and also on FDI. Chile and Colombia had provided for a non-interest bearing reserve requirement (of between 33 per cent to as much as 48 per cent of the total inflow) to be held for one year with the central bank to ensure that the inflows were not of a speculative nature.

For portfolio capital, other specific measures are possible. In some countries, foreigners are prevented from purchasing domestic debt instruments and corporate equity. The extent of foreign portfolio investment (FPI) penetration in the domestic stock market can be regulated, with a limit on the proportion of stocks held by such foreign investors. Exit levies can be imposed that are inversely proportional to the length of the stay, meaning that capital which leaves the country sooner is subject to a higher tax. In any case, differential rates of taxation provide an important means of regulating capital flows and can be flexibly adjusted to suit different conditions and changing circumstances.

In the case of external commercial borrowing, some countries have imposed a tax on foreign loans. Others have provided fiscal incentives for domestic borrowing and investment. Domestic banking regulations can also play an important role in ensuring that private external debt does not reach undesirable proportions and in directing resources towards particular sectors.

The international financial press tends to portray such controls as rigid and as acting as disincentives to investment. But the reality is very different – experience shows that these controls can be, and have been, used flexibly and altered in response to changing circumstances. Furthermore, they have typically not acted as a disincentive to

[5] Epstein, Grabel and Jomo (2004) outline various strategies already used by different developing countries.

continued capital inflows of the desired variety; instead, they have ensured that such inflows actually contribute to increasing investment in socially effective ways. It is worth noting that China, which still retains the largest number and most comprehensive of controls over all forms of capital flow among all countries, has also been the largest recipient of capital inflows in the developing world.

Some capital control measures may be required not only to prevent crises and excessive changes in the exchange rate, which render the economy externally uncompetitive, but also to enable the continuation of domestic financial policies that promote sustainable industrialization. It should now be obvious that some role for directed credit is essential not only to ensure a sustained industrialization strategy but also in order to ensure that the goals of employment generation and social equity are met.

Similarly, controls over domestic financial activity and the regulatory role of the central bank need to be emphasized in order to prevent domestic financial crises and excessive cyclical volatility. Prudential controls of the kind promoted by the Bank for International Settlements are not the obvious solution, since they tend to be pro-cyclical in their effects, are too greatly determined by the context and requirements of developed countries and are insufficiently flexible for developing countries (Griffith-Jones and Ocampo, 2004).

So, there is a strong case for developing countries to ensure that their own financial systems are adequately regulated with respect to their own specific requirements, which may vary substantially, depending upon the size and nature of their economies, the extent of external integration, the relative importance of the banking system vis-à-vis the capital market, and so on. All this means that blindly following the Anglo-Saxon model of financial systems is neither necessary nor desirable; indeed, the more successful developing country industrializers have been those who have adopted much more unique and controlled financial regimes.

One pervasive myth that deserves to be shattered is that greater international trade exposure and trade dependence necessarily require greater financial integration and both internal and external financial liberalization. In fact, the most successful trading economies of the recent past have been those which have relatively more controlled financial systems. China is, of course, the best example, where a major export boom and rapid trade dependence have been associated with a financial system which allows the Government not only to systematically channel credit in desired areas, but also to use this as a major macroeconomic instrument for demand management and smoothing business cycles. The rapid expansion of Chinese enterprise does not appear to have been inhibited by such controlled credit, even in the period when mainland Chinese entrepreneurs could not directly access bank credit; neither has the growing integration of China with the world economy been hampered by the absence of any capital market worth the name. In fact, future economic historians may even find that such controlled credit was an important factor behind the rapid export-led industrialization drive.

Finally, it is worth considering the argument that more controlled financial systems encourage opacity, corruption and “crony capitalism”, all of which are not only wasteful of resources but can lay the grounds for subsequent crises. This is the view of those who have, for example, blamed the East Asian financial crises of the late 1990s on such financial control-based “crony capitalism”. It is, of course, no one’s case that corruption is either desirable or even acceptable; however, it should nevertheless be noted that high levels of “corruption” and “crony capitalism” have had little effect on reducing the level of per capita income or retarding the rate of economic growth, as the experience of countries as far afield as Japan and the United States makes amply clear.

Further, the real solution for such problems is to encourage greater openness about the direction of finance and to increase public accountability of such financial transactions, rather than leave socially important decisions of resource allocation to the workings of private financial markets that are neither accountable nor transparent and that, in any case, are prone to various types of market failure. While corruption is an ever-present danger, it is so under all financial systems, the most deregulated and market-determined ones. Financial liberalization in the name of reducing corruption therefore does not reduce the possibility or likelihood of corruption, while it exposes the economy to myriad risks and reduces the capacity of the State to promote autonomous and sustainable development.

Clearly, therefore, if the development project is to continue at all in large parts of the world where it remains essentially partial and incomplete, some government control over the financial sector remains essential. This, in turn, means that strategies that are only concerned with the “sequencing” of liberalization measures are asking the wrong question. The real question should be: Which financial controls should be maintained, restored or introduced in order to ensure a viable, stable and socially desired pattern of development?

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