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Financial Policy; A Training Module of the Research Programme: Economic Policies

Gerald A. Epstein

University of Massachusetts - Amherst

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Training Module

Training Modules of the Research Programme Economic Policies, MDGs and Poverty

Gerald Epstein

Professor of Economics and Co-Director
Political Economy Research Institute (PERI)
University of Massachusetts, Amherst

and

Ilene Grabel

Professor of International Finance
Graduate School of International Studies
University of Denver



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FINANCIAL POLICY



1 INTRODUCTION

A PRO-POOR GROWTH APPROACH TO FINANCIAL POLICY

This module describes the current state of knowledge with respect to pro-poor growth financial policies.¹ These policies are presented as alternatives to what, we argue, are the failed financial policies inspired by orthodox economics. Orthodox financial policies, also known as 'Washington Consensus' policies, have been implemented in a large number of developing countries over the last quarter century. We explore the logic of these financial policies and examine the diverse ways in which they have failed the developing world.

The principal goals of this module are to present a range of financial policies that have been utilized in some countries to promote pro-poor growth at various times, and also to present a set of more innovative policies that have not yet been utilized, but which we argue can also support pro-poor growth. We maintain, in fact, that there exists a wealth of such experiences and strategies available to practitioners in the developing world.

"Domestic financial liberalization has unambiguously failed to deliver most of the rewards claimed by its proponents".

1.1 A BRIEF REVIEW OF HISTORICAL EXPERIENCE

If the 1950s and 1960s were the 'golden age' of capitalism in the industrialized world, then in much of the developing world, this period should be remembered as the age of the 'developmental state' [Marglin and Schor, 1990; Wade, 1990; Amsden, 2001]. In many parts of the developing world, especially those that had recently won independence from colonial powers, the state was seen as a general agent of economic development. Its prescribed tasks included mobilizing and directing savings for industrialization; using industrial and trade policy (including tariffs) to guide investment and industrial development; implementing financial market regulations (including capital and exchange controls) to marshal domestic and international financial resources for domestic investment and to manage the country's relations with the international markets; and using government ownership of given financial and industrial firms to control the rate and direction of investment, to generate employment and to address various social problems, such as poverty [e.g., Nembhard, 1996; Woo-Cumings, 1999]. Many developing countries, such as India, Brazil, Argentina, Taiwan POC, Republic of Korea, Singapore, South Africa and Ghana, used such diverse types of policies to industrialize and to promote economic growth and improvements in living standards.

In the area of finance, many developing country states were especially active. These countries were taking a leaf from Alexander Gerschenkron's famous thesis that 'late developers' had to make use of special financial institutions to mobilize and channel savings for long-term investment and growth because of the scale and complexity involved in catching up to global leaders [Gerschenkron, 1962]. Moreover, significant involvement by the state in the area of finance was in keeping with the general tenor of the times, which had perceived the calamitous role of private finance in the disastrous collapse of the world economy in the 1930s [Helleiner, 1994; Kindleberger, 1973]. During this period, a variety of state-owned, state-regulated or state-directed financial institutions were created to mobilize and channel credit to agricultural and industrial sectors of the economy, as well as to important social sectors such as housing and education.

Significantly, these policies of state management and direction of finance were used widely not only in many developing countries, but also in the developed world [Zysman, 1983]. In countries with economic systems as diverse as those in Japan, France, the United States and Germany, financial regulations and state-owned or state-directed banks were used for a range of economic and social purposes, including subsidizing housing, supporting industrial policy and export promotion, promoting small businesses and financing infrastructure development [Pollin, 1995; Grabel, 1997; Epstein, 2006].

In the era of the developmental state, central banks in developing countries often cooperated with or were under the control of governments. These 'developmental central banks' supported the state's developmental goals through a variety of tools and mechanisms, including subsidizing credit and regulating financial institutions to direct credit to specific purposes [Bloomfield, 1957; Brimmer, 1971]. In fact, as a marker of the times, many of these developmental central banks were established with the help and advice of the New York Federal Reserve, which today would arguably have no part of such advice [Helleiner, 2003]. This type of central bank practice, of course, contrasts radically with today's orthodox vision of central banks, institutions that are exhorted to be politically independent of governments and to focus primarily, if not exclusively, on keeping inflation in the low single digits.

As prominent Federal Reserve economist and historian Arthur Bloomfield noted:

“Many of the central banks, especially those established since 1945 *with the help of Federal Reserve advisers* (emphasis added) are characterized by unusually wide and flexible powers. A large number of instruments of general and selective credit control, some of a novel character, are provided for. Powers are given to the central bank to engage in a wide range of credit operations with commercial banks and in some cases with other financial institutions... These and other powers were specifically provided in the hope of enabling the central banks... to pursue a more *purposive* (emphasis added) and effective monetary policy than had been possible for most... that had been set up... during the twenties and thirties... which permitted little scope for a monetary policy *designed to promote economic development and internal stability* (emphasis added)...” [Bloomfield, 1957, p. 191].

It was a sign of the times, then, that even the U.S. Federal Reserve System was helping developing countries create developmental central banks.

As we discuss in the next section, the post-war vision of developmental central banking and financial policies in the service of pro-poor growth fell out of fashion as part of the general reassertion of orthodox economic theory and policy in the mid-to-late 1970s. In the financial arena, the reassertion of orthodox economics was embodied in the adoption of policies of internal and external financial liberalization, the creation of independent central banks and the use of inflation targeting [on the latter, see Saad Filho, 2006; Epstein, 2002, 2005].

We will see that these orthodox policies have been associated with reductions in inflation relative to its high levels in the 1980s. But these same policies have also been associated with serious pathologies: recurrent financial crises (e.g., in Turkey in 1992, Mexico in 1994, East Asia in 1997 and Argentina in 2001); major increases in domestic and, by some measures, in global inequality [Milanovic, 2005]; slower economic growth and even stagnation in some parts of the world, particularly in sub-Saharan Africa; and increases in unemployment or underemployment in many parts of the developing world. In view of these failures, the time is ripe to consider new approaches to domestic, central bank and external financial policies.

1.2 PRINCIPLES OF FINANCIAL POLICIES FOR PRO-POOR GROWTH

Before we consider policy alternatives, we have to answer the following question: What do we mean by pro-poor growth financial policies? At one level, this is quite easy to answer. We will describe policies and institutions that are designed to mobilize and channel savings, allocate credit in accordance with identified social and economic objectives, and promote financial and macroeconomic stability with the goal of promoting growth that will generate employment, income and wealth for the poor.

To achieve these outcomes, financial policies have to serve general purposes, as well as specific purposes related to the needs of particular countries and regions. More precisely, the financial sector can play an important and productive role in promoting pro-poor growth through the following channels:

- Mobilize savings for productive investment and employment generation;
- Create credit for employment generation and poverty reduction at modest and stable real interest rates;

- Allocate credit for employment generation and help the poor to build assets, including in agriculture, in small- and medium-sized enterprises and in housing;
- Provide patient (long-term) credit for productivity-enhancing innovation and investment;
- Provide financing for public investment to provide for employment generation and productivity enhancement;
- Help to allocate risks to those who can most easily and efficiently bear such risks;
- Help to stabilize the economy by reducing vulnerability to financial crises and pro-cyclical movements in finance, and by helping to maintain moderate rates of inflation;
- Help the poor by providing basic financial and banking services.

1.3 GOALS AND ORGANIZATION OF THE MODULE

The chief goal of this Training Module is to describe how the diverse parts of the financial sector (namely, the domestic and external sectors and the central bank) can play the roles described above. In section 2 of this module we describe the logic and the (failed) performance of the financial policies inspired by orthodox economic theory. In section 3 we present a snapshot of the problematic state of the financial environment in developing countries today. Sections 4-6 are the heart of this module insofar as they present a range of financial policies that can be used to promote pro-poor growth. Section 4 presents policies for the domestic financial sector, section 5 policies for developmental central banks, and section 6 policies toward external financial flows.

2 ORTHODOX APPROACHES TO FINANCIAL POLICY IN DEVELOPING COUNTRIES

Having made a case for pro-poor financial policy above, we now consider an alternative logic that we term the orthodox view. The orthodox view has driven the financial policy decisions made in most (but not all) developing and wealthy countries over the last quarter century. There are many reasons for the shift toward orthodox financial policies. These include advocacy on the part of the U.S. and U.K. governments and of the Bretton Woods and other multilateral institutions; widespread acceptance of orthodox economic theory; increased power and autonomy of the financial sector both globally and nationally; and the attempt by policymakers in developing countries to use open financial markets as magnets for international capital flows.

In this section, we explain the theoretical basis of the orthodox case for liberalization (i.e., deregulation) of the domestic financial sector and of international capital flows. Although in practice they are often treated together, we discuss these two dimensions of liberalization separately in sections 2.1 and 2.2, respectively, for the sake of clarity. Note that the reduction of poverty is not central to the orthodox case for financial liberalization. Nevertheless, liberalization is seen to benefit the poor through numerous channels. In section 2.3 we will briefly review the performance of the financial reforms inspired by the orthodox view. We will see that this policy has failed to achieve its chief goals and that it has aggravated critical problems (such as poverty, inequality and instability). These failures stand in sharp contrast to the limited successes that can be attributed to financial liberalization, as we will also see.

2.1 THE ORTHODOX CASE FOR LIBERALIZATION OF THE DOMESTIC FINANCIAL SECTOR²

Orthodox economists maintain that when state regulation of domestic finance was the norm—from the end of WWII until the mid-to-late 1970s—it was counterproductive. Today, such policies continue to be seen as counterproductive in the few developing countries that remain committed to active state involvement in finance. Orthodox economists use the ideologically-charged term ‘financial repression’ to describe financial systems that are actively regulated in accordance with state development goals. Such systems tend to be dominated by banks whose decisions are influenced by governments, rather than by capital (i.e., stock and bond) markets.

In the orthodox view, active state involvement in the financial sector has a number of adverse consequences. The maintenance of low interest rates (particularly in the context of high inflation) encourages domestic savers to hold funds abroad and makes current consumption more attractive than saving in domestic financial institutions. High levels of consumer spending can put upward pressure on prices and thereby aggravate inflationary pressures. Low savings rates also mean that domestic banks have an insufficient pool of savings from which to extend loans. The level of domestic investment is thus compromised by active financial regulation, and employment and economic growth suffer accordingly. It is through employment, growth and price channels that orthodox economists maintain that state involvement in finance negatively affects living standards and poverty.

Furthermore, orthodox economists contend that active state involvement in finance fragments domestic financial markets, with only a small segment of politically-connected borrowers gaining access to scarce low-cost credit. Disenfranchised borrowers must either resort to unregulated ‘informal’ (or ‘curb’) lenders, who often charge exorbitant interest rates, or otherwise manage in the face of their unmet needs for capital. Entrepreneurship, employment-creation and growth therefore suffer. These negative effects are disproportionately experienced by the poor since the burden of scarce credit hits them hardest. They rarely have access to alternative, lower-cost sources of credit, such as the finance available on international capital markets.

In view of the above, orthodox economists argue that developing countries must liberalize their domestic financial systems. A liberalized financial system with a competitive capital market is seen as central to the promotion of high levels of savings, investment, employment, productivity, foreign capital inflows and growth. From this perspective, liberalized systems serve the interests of the poor and the disenfranchised (as well as other groups) by increasing access to capital, with attendant benefits for employment, investment and growth.

Orthodox economists also maintain that domestic financial liberalization increases not only the level of investment, but also its quality (i.e., its efficiency) by allocating funds across investment projects according to rate-of-return criteria and via what are seen as objective or ‘arms-length’ practices. Domestic financial liberalization is seen to improve the overall efficiency of the financial system by eliminating the wasteful and corrupt practices that flourish under financial regulation, as well as by subjecting borrowers and firm managers to market discipline. Market discipline and reduced corruption improve the operating performance of financial institutions and consequently enhance the prospects for financial stability.

In the orthodox view, liberalization has other benefits. It encourages the creation of new financial instruments (e.g., derivatives) and of markets in which to trade them. This is termed financial innovation. Investment and financial stability are promoted by new opportunities to diversify and disperse risk. By increasing the availability of finance, liberalization also eliminates the need for informal finance, which often exploits the poor, and allows borrowers to utilize the forms of finance that are most appropriate to their investment projects.

Orthodox economists see the finance provided through capital markets as preferable to bank loans because it is understood to have a greater ability to disperse risk, is allocated according to objective efficiency and performance criteria, is cheaper than other forms of external finance (such as bank loans) and is highly liquid. The liquidity attribute is considered especially desirable because it places firm managers under the threat of investor exit (or higher capital costs) if they underperform. (See section 2.2 for further discussion.) The promotion of internationally-integrated capital markets has the added benefit of facilitating the rapid integration of developing countries into the global financial system.

Some orthodox economists argue that full domestic financial liberalization can be attained only once other sectors of the economy (such as tradable goods and labour markets) are well functioning and liberalized. This is known as the sequencing view. However, many orthodox economists reject arguments for sequencing because of the problems introduced by this strategy (such as the possibility that it gives time for interest groups to mobilize to block liberalization). Despite the debate about the speed and sequencing of liberalization among some orthodox economists, there is no dispute among them that a liberalized domestic financial sector is the ideal to be attained by developing countries.

2.2 THE ORTHODOX CASE FOR LIBERALIZATION OF INTERNATIONAL CAPITAL FLOWS

In the orthodox view, there are numerous benefits associated with unfettered international private capital flows. Open capital markets give the public and private sectors access to capital and other resources (such as technology) that are not being generated domestically. Sufficient capital and other resources are not generated domestically because of low income, savings and growth and capital flight. Thus, orthodox economists maintain that an increase in private capital inflows will inaugurate a virtuous cycle by increasing a nation's capital stock, productivity, investment, economic growth and employment. All of these benefits redound to the advantage of society as a whole, and particularly to that of the poor, since higher levels of investment increase overall employment opportunities, especially in the modern, technologically advanced firms that are financed by foreign investment. Likewise, the sale of government bonds to foreign investors increases the resources available for public expenditure, resources that are often scarce due to tax collection problems and the myriad demands on budgets. The poor will also benefit if the new spending is oriented in their direction.

Orthodox economists also argue that international private capital flows increase efficiency and policy discipline. The need to attract private capital flows and the threat of capital flight (by domestic and foreign investors) are powerful incentives for the government and firms to maintain international standards for 'good policy,' macroeconomic performance and corporate governance. Specifically, orthodox economists maintain that governments seeking to attract international private capital flows are more likely to pursue anti-inflationary policies and anti-corruption measures because foreign investors value price stability, transparency and the rule of law. The poor benefit from stable prices and transparency since they are less able than the rich to hedge against inflation or extract benefits from corrupt regimes.

Liberalization of international capital flows means that a greater proportion of total financial flows will be allocated by capital markets or foreign banks that are not influenced by developing country governments. In the orthodox view, this shift in the allocation mechanism increases efficiency and ensures that finance is directed towards projects that promise the greatest net contribution to social welfare. These are the projects promising the highest rates of return. Here,

too, there is an assumed benefit to the poor as they stand equal to the rich and the politically connected in the competition for capital in internationally integrated markets.

For the reasons advanced above, orthodox economists hold that liberalization of capital flows is essential to promote sound economic performance, particularly with regard to investment and growth. Indeed, had the East Asian financial crisis of 1997-98 not intervened, the IMF was poised to modify Article 6 of its Articles of Agreement to make the liberalization of international private capital flows a central purpose of the Fund and to extend its jurisdiction to capital movements.

Similarly with respect to domestic financial liberalization, some orthodox economists argue that the liberalization of international capital flows (especially the most liquid of these) should be undertaken only *after* successful liberalization of other sectors or the attainment of sufficient institutional and regulatory capacity. Advocates of sequencing generally find their case strengthened following financial crises because these are held to be a consequence of premature external financial liberalization. Notably, following the East Asian crisis, some studies, even by IMF staff, acknowledged that certain techniques for managing international capital flows can prevent undue financial volatility, *provided* that capital management techniques are temporary and that the rest of the economy is liberalized [e.g., Prasad, Rogoff, Wei, Kose, 2003; Kuczynski and Williamson, 2003]. Note that even among advocates of sequencing, there is no question that complete liberalization is the *ultimate goal* for *all* developing countries.

2.3 THE PERFORMANCE OF LIBERALIZED FINANCIAL SYSTEMS

Financial liberalization has been the norm in developing countries in the last quarter century. The policy has enjoyed a few successes and suffered numerous unambiguous failures.

On the positive side of the balance sheet, liberalization has furthered the integration of developing countries into global markets. This has meant that certain large firms, especially in the context of privatization programs, have received significant finance through the internationally integrated capital markets created or expanded following financial liberalization. The finance provided to these firms has often been cheaper than that available via bank loans. Counterfactually, it is at least plausible to assume that the investment levels of firms that have gained access to new pools of finance have probably been higher than they would have been in the absence of liberalization. Financial liberalization has meant that governments have been able to raise (i.e., borrow) funds on international capital markets. Middle-class consumers may also have benefited from access to international credit markets and from the opportunity to diversify their portfolios internationally. Finally, the higher interest rates associated with financial liberalization, together with the adoption of inflation targeting programs, have helped to lower rates of inflation in developing countries.

However, even these achievements are not without complications. The growth of large firms (and the contraction of small firms that cannot afford to borrow at high interest rates) has increased business concentration. The lower-cost capital that has become available to certain large firms after financial liberalization has fuelled speculative bubbles in many countries. Moreover, capital markets reinforce rather than undermine existing dualisms characterized by greater access to lower-cost external finance by large firms. There is no evidence that the growth of capital markets increases access to finance or lowers its cost for those entrepreneurs who have long faced severe capital constraints.

Indeed, as McKinley notes, following financial liberalization, commercial banks have concentrated their activities in the major urban areas of developing countries. He goes on to

explain that “although aggregate statistics of financial deepening might have improved following financial liberalization, access to credit has become, if anything, more unequal. The rural population remains deprived of credit in most countries, and is likely worse off compared to the access to credit that state-owned agricultural banks had previously provided” [p. 21]. McKinley [2005:23] concludes that, in the African case, the private sector has had even less access to credit after financial liberalization than before it.

Large foreign-owned banks come to play a greater role in the domestic financial system following the removal of restrictions on their presence. Large foreign-owned banks that generally enter developing countries after liberalization are not responsive to the needs of small- and medium-sized enterprises (SMEs) [see Weller, 2001b]. Interestingly, a study of large banks in the U.S.A. finds that they are less willing to lend to small firms than are smaller banks [Berger et al., 2001]. This finding should give policymakers in developing countries an additional reason to be cautious when abandoning restrictions on cross-border and domestic bank mergers as part of liberalization programs because this can aggravate the serious financing constraints already faced by SMEs.

There is a large body of empirical evidence demonstrating that domestic financial liberalization has unambiguously failed to deliver most of the rewards claimed by its proponents [e.g., Arestis and Demetriades, 1997; Williamson and Mahar, 1998; Zhu, Ash and Pollin, 2004, 1998; Ang and McKibbin, 2005]. Domestic savings have not responded positively to liberalization. Financial liberalization has not promoted long-term investment in the types of projects or sectors that are central to development and to the amelioration of social ills, such as unemployment, poverty and inequality. Financial liberalization has created the climate, opportunity and incentives for investment in speculative activities and has directed the focus to short-term financial as opposed to long-term developmental returns. Granted, the creation of a speculative bubble may temporarily result in an increase in investment and overall economic activity. However, an unsustainable and financially fragile environment, or what Grabel [1995] terms ‘speculation-led development’, is hardly in the long-term interest of developing countries. Such an environment certainly does not improve the situation of the poor—indeed it worsens their conditions of life, as we will see.

One channel by which the speculation-led development induced by financial liberalization worsens the condition of the poor is through its effect on financial fragility, and ultimately on the prevalence of currency, banking and overall financial crises. Many empirical studies find that financial liberalization often leads to currency and banking crises [see Grabel, 2003b, and references therein]. Chile, Argentina and Uruguay experienced financial collapses following their experiments with liberalization in the mid-1970s. Since then we have seen financial crises on the heels of liberalization in a great many developing countries, such as Russia, Nigeria, Jamaica, Republic of Korea, Thailand, Indonesia, Mexico and Turkey. Contrary to the orthodox view, the financial innovation and associated increase in liquidity that follow liberalization impart greater risk and instability to the financial system and the economy. The promotion of capital markets—especially when they are internationally integrated and liberalized—exacerbates the problem of financial fragility that so frequently culminates in crises, the burdens of which always fall disproportionately on the economically vulnerable and politically weak groups within society.

Financial liberalization also can worsen the situation of the poor by increasing income and wealth inequality and by aggravating existing disparities in political and economic power. Only a very small proportion of the population is situated to exploit the opportunities for speculative gain available in a liberalized financial environment. Speculation-led development often creates a small class of financiers who have stronger ties to financial markets abroad than to those in their own

country. It is also associated with shifts in political and economic power from non-financial to financial actors [Grabel, 2002; Harvey, 2005; Panitch and Gidgin, 2004;]. In such an environment, the financial community becomes the anointed arbiter of the 'national interest' [Grabel, 2003b]. This means that macroeconomic policies that advance the interests of the financial community (such as those that promote low inflation, high interest rates and fiscal restraint) are justified on the basis that they serve the broader public interest when, in fact, this is rarely the case. Indeed, restrictive macroeconomic policies have a disproportionately negative effect on the poor and women [Braunstein and Heintz, 2006].

Orthodox economists often herald the disciplining effects of capital markets, arguing that the threat of investor exit and corporate takeovers creates pressure to improve corporate governance. We know that the exit and takeover mechanisms are well developed in the markets of the U.S.A. and the U.K., but there is simply no evidence to support the argument that these mechanisms have, on balance, been beneficial. Indeed, numerous studies find that the threat of investor exit shortens the time horizon of managers, while takeovers have increased concentration and induced job losses. The contention that developing country firms and consumers benefit from the greater possibility of exit and takeover is therefore without merit.

It should also be noted that there is no demonstrated empirical or historical relationship between a market-based allocation of capital and the satisfaction of growth and social objectives. This is not surprising since the allocation of capital in market-based systems relies on private financial returns (i.e., profits) as the single yardstick of investment success. The private financial return on an investment can be quite different from its developmental (or what we might term its social) return. For example, the developmental return on an investment in the provision of clean water is likely to exceed its private return. The divergence between private and developmental returns means that alternatives to the market-based allocation of capital are necessary to promote investment that is socially necessary, but not necessarily privately profitable.

Moreover, despite the claims of orthodox economists, a market-based allocation of capital is not a magic cure for inefficiency, waste and corruption. Liberalization frequently changes the form, but not the level, of corruption or inefficiency. The situation of Russia after financial liberalization exemplifies this point, but the country is by no means exceptional in this regard [on Russia, see Kotz, 1997]. For instance, research on Nigeria, Republic of Korea and South America describes quite persuasively the corruption that so often flourishes following financial liberalization [Burkett and Dutt, 1991; Chang, 1998; Crotty and Lee, 2004; Lewis and Stein, 1997]. Thus, financial liberalization does not resolve the problem of corruption and the lack of transparency that frequently operate to the detriment of the poor.

As with domestic financial liberalization, the case for liberalizing international capital flows is not supported by evidence. Numerous recent cross-country and historical studies demonstrate conclusively that there is no reliable empirical relationship between the liberalization of capital flows and performance in terms of inflation, economic growth or investment in developing countries [e.g., Eichengreen, 2001; Rodrik, 1998; Lee and Jayadev, 2006]. Moreover, there is now a large body of unambiguous empirical evidence that shows that the liberalization of international private capital flows is strongly associated with banking, currency and financial crises [Demirgüç-Kunt and Detragiache 1998; Weller 2001a].

Studies also show that liberalization is associated with increases in poverty and inequality, though the authors of these studies take care to point out that it is difficult to isolate the negative effects of financial liberalization from those associated with broader programs of economic liberalization (involving, for instance, the simultaneous adoption of trade and labour market

liberalization). With this caveat in mind, it is worth noting that Weller and Hersh [2004] find that capital and current account liberalization hurt the poor in developing countries in the short run. The poor are harmed through a chain of related effects that have been established in several studies.

Increased short-term international financial flows (especially portfolio flows) are often associated with a greater chance of financial crisis [Kaminsky and Reinhart, 1999; Weller, 2001a], especially in more liberalized environments [Demirgüç-Kunt and Detragiache, 1999]; financial crises have disproportionately negative consequences for a country's poor [Baldacci et al., 2002; Frankenberg, et al., 2002]; low-income earners are more likely to be affected by declining demand as unemployment rises following a financial crisis [Eichengreen, et al., 1996]; and the poor are the first to lose under the fiscal contractions and the last to gain when crises subside and fiscal spending expands [Ravallion, 2002].

Cornia [2003] also finds a good deal of suggestive evidence that financial liberalization has a negative impact on the poor (he also brings together evidence from a variety of studies). Of the six components of what he terms the "liberal package," Cornia finds that capital account liberalization apparently has the strongest impact on widening within-country inequality. He finds that the next most important negative effects on the poor derive from domestic financial liberalization, followed by labour market deregulation and tax reform. Finally, Weisbrot et al. [2001] conclude that there is a strong *prima facie* case that some structural and policy changes implemented during the last two decades, such as financial liberalization, are at least partly responsible for worsening growth and health and other social conditions.

Liberalized financial markets are at least as apt as governments to allocate international capital flows in an inefficient, wasteful or developmentally unproductive manner. In many developing countries, readier access to international flows following liberalization has financed speculation in commercial real estate and the stock market, created excess capacity in certain sectors, and allowed domestic banks and investors to take on positions of excessive leverage, often involving currency and locational mismatches culminating in crises.

The liberalization of capital flows frequently leads to exchange rate problems that spill over to other sectors of the economy. Under a system of market-determined (i.e., floating) exchange rates, large, sudden inflows of capital to a country can pressure the domestic currency to appreciate. A large appreciation of the domestic currency is problematic because it can undermine the country's balance of payments position. The flipside of capital inflows is, of course, the possibility of capital outflows (e.g., dividend payments to foreign investors, interest payments to foreign lenders and the liquidation of stock portfolios). Sudden, large capital outflows can pressure the domestic currency to depreciate.

Capital flight often induces a vicious cycle of additional flight and currency depreciation, debt-service difficulties and reductions in stock (or other asset) values. Panicked investors tend to sell their assets *en masse* to avoid the new capital losses brought about by anticipated future depreciations of currency or asset values [Taylor, 1991]. In this manner, capital flight introduces or aggravates macroeconomic vulnerabilities and financial instability. This process can culminate in a financial crisis, an event that seriously compromises economic performance and living standards (particularly for the poor) and often provides a channel for increased foreign influence over domestic decision-making.

Finally, on surveying the data, it becomes obvious that international private capital flows cannot perform the Herculean tasks assumed by orthodox economists. Before turning to the data, let us clarify the terminology. International private capital flows consist of four main types—foreign

bank lending, portfolio investment (PI), foreign direct investment (FDI) and remittances. Foreign bank lending refers to the loans extended by commercial banks or multilateral institutions to domestic public or private sector borrowers. PI refers to the purchase of stocks, bonds, derivatives and other financial instruments issued by the private sector in a country other than that in which the purchaser resides. In the case of bonds, the instruments can also be issued by the government and purchased by private investors.

FDI refers to the purchase of a 'controlling interest' (defined as at least 10 per cent of the assets) in a business in a country other than that in which the investor resides. FDI can take two forms: 1) 'greenfield' investment, which involves the creation of a new facility, e.g., the construction of a factory by a foreign investor; or 2) 'brownfield' investment, namely, mergers and acquisitions that involve the purchase of assets of existing domestic firms. The cross-border purchase of real estate is also classified as FDI. Private remittances refer to international resource transfers between individuals. The most common type of remittance occurs when a family member who is working abroad sends funds (i.e., wage remittances) to a family member in the home country.

Data on international private capital flows show that despite the growth of PI and FDI flows to developing countries during the 1990s, their share of global private capital flows is still small and remains highly concentrated in a few large countries.³ With regard to concentration of FDI, Brazil, China, India, Mexico and the Russian Federation received just over 60 per cent of net FDI inflows to all developing countries in 2004, while China accounted for one-third of the net FDI inflows that went to all developing countries. In 2003/2004, low-income countries received about 11 per cent of net FDI and the same percentage of portfolio equity flows that went to all developing countries. China, India and South Africa together accounted for 82 per cent of all portfolio equity flows that went to developing countries in 2004, while China alone accounted for almost 40 per cent of the net PI that went to all developing countries.

Inflows of private remittances are becoming an increasingly important part of the financial landscape in some developing countries and regions. As in the case of PI and FDI, remittance inflows are also highly concentrated within a group of developing countries. In terms of the dollar value of remittances, the five main recipient countries are India, Mexico, China, Pakistan and the Philippines [World Bank, 2005]. In 2003 these five countries received almost 84 per cent of the remittances that went to all developing countries. In 2004 low-income countries received 35 per cent of the remittances that went to all developing countries. This concentration means that the potential of many developing countries to harness remittances in the service of pro-poor growth is limited.

There is no reason to expect these trends in the concentration of international private capital flows to reverse in the near future. Thus, it is imperative that advocates of pro-poor financial policy recognize the importance of strategies that both mobilize domestic savings in service of pro-poor growth, and maximize the potential of international private capital flows received to serve this agenda. We consider such mechanisms in sections 4-6 of this module.

3 CHALLENGES OF CURRENT FINANCIAL STRUCTURES

In many developing countries, the financial structures are failing to promote development and poverty reduction. The same can be said of the global financial system. In what follows, we highlight six key problems with current financial structures in the developing world.⁴

CHALLENGE #1: HIGH REAL INTEREST RATES AND WIDE INTEREST RATE SPREADS

Despite financial liberalization, interest rate spreads and real interest rates remain very high in a number of developing countries. Table 1 shows that in 2003, differences between interest rates on deposits and those on lending were extremely high in a number of poor countries, while in many of them real interest rates remained above 10 percentage points.

TABLE 1

Interest Rate Differential and Real Interest Rate, 2003

Country	Deposit Interest Rate 2003	Lending Interest Rate 2003	Real Interest Rate 2003
Armenia	6.9	20.8	15.5
Bangladesh	7.8	16.0	11.0
Bolivia	11.4	17.7	11.9
Cambodia	2.0	18.5	15.9
Cameroon	5.0	18.0	16.9
CAR	5.0	18.0	14.9
Gabon	5.0	18.0	19.4
Honduras	11.5	20.8	11.2
Kyrgyz Republic	5.0	19.1	14.8
Lao PDR	6.6	30.5	11.8
Mongolia	14.0	26.3	20.6
Nicaragua	5.6	15.5	9.4
Tanzania	3.0	14.5	8.3
Uganda	9.8	18.9	8.0
Zambia	22.0	40.6	17.1

Source: *World Development Indicators 2005*, Table 5.7.

Clearly, with real interest rates and spreads such as these, the financial intermediation process in developing countries cannot contribute greatly to real capital formation, and financial intermediation certainly cannot speak to the needs of the poor or small- and medium-sized businesses.

CHALLENGE #2: CREDIT CREATION IS TOO LOW

In many poor countries, high spreads and real interest rates are associated with relatively low rates of credit creation. Table 2 shows that in low-income countries, including sub-Saharan Africa, interest rate spreads and the amounts of credit available lag behind other regions of the world, where financial conditions are more favourable. In most of sub-Saharan Africa, domestic credit creation to the private sector is lower than the 63.7 per cent of GDP shown because the high rate in South Africa substantially raises the average for the rest of the region (See Tables 2 and 3).

TABLE 2

Performance Indicators of Financial Institutions, 2003

	Low-Income Countries	Sub-Saharan Africa	South Africa	South Asia	East Asia and the Pacific	Middle- Income Countries
Domestic Credit to the Private Sector (% of GDP)	27.0	63.7	158.2	31.0	123.6	64.2
Interest Rate Spread ^a (percentage points)	12.4	12.4	5.2	7.3	5.2	6.3

Sources: McKinley, 2005. World Bank, *World Development Indicators 2005*, Table 5.5

Note: 'a' lending minus deposit rate.

Table 3 provides country-by-country and country-group information concerning domestic credit to the private sector overall, and domestic credit from the banking sector to the overall economy, including the government. For a large number of countries and for low income countries as a whole, there has been very little increase, and, in many cases, a decrease in the amount of credit to the private sector and to the economy as a whole from banks, the dominant financial institution in these countries. By contrast, in the middle and high income countries, there has been a substantial increase.

TABLE 3

Domestic Credit Provided to the Private Sector and Credit Provided by the Banking Sector, Percentage of GDP, 1990 and 2003

Country	Domestic Credit to the Private Sector 1990	Domestic Credit to the Private Sector 2003	Domestic Credit Provided by the Banking Sector 1990	Domestic Credit Provided by the Banking Sector 2003
Armenia	40.4	6.0	58.7	5.5
Bangladesh	16.7	28.8	23.9	38.4
Bolivia	24.0	49.0	30.7	60.0
Cambodia	---	7.9	---	7.2
Cameroon	26.7	10.2	31.2	16.0
CAR	7.2	5.9	12.9	14.7
Gabon	13.0	10.8	20.0	17.5
Honduras	31.1	40.6	40.9	37.7
Kyrgyz Republic	---	4.8	---	11.4
Lao PDR	1.0	6.5	5.1	10.1
Mongolia	19.0	30.3	72.4	38.0
Nicaragua	112.6	26.4	206.6	96.5
Tanzania	13.9	7.6	34.6	8.4
Uganda	4.0	6.9	17.8	12.5
Zambia	8.9	6.7	67.8	38.2
Low Income	22.3	27.0	44.3	45.3
Middle Income	43.0	64.2	64.3	85.3
High Income	125.8	158.3	153.1	181.9

Source: *World Development Indicators 2005*. Table 5.7; Table 5.5.

In most of these countries, credit creation relative to GDP fell between 1990 and 2003, while for all low income countries, it rose somewhat, but is still at low levels relative to other regions of the world.

CHALLENGE #3: GLOBAL SAVINGS ARE SEVERELY MISALLOCATED

Are savings rates too low? In some cases yes, but a more serious issue is that savings are severely misallocated globally. As table 4 shows, in recent years a handful of rich countries, most notably the United States, has been running savings shortfalls relative to investment, while many other regions of the world have been saving more than they have been investing. As a result, poorer countries have become net lenders of resources to the United States, or have borrowed from the rest of the world much less than they had in earlier periods. In short, globally speaking, resources are being shifted from most of the world, including many relatively poor or middle income countries, to the United States. In recent years, then, the United States has been utilizing an enormous share of the world's savings. As Aizenman et al. [2004] confirm, most developing countries self-finance their own investment, making little productive use of the global capital market. Yet, as we have just seen, many poor countries are not being served well by domestic financial markets either.

TABLE 4

Trends in Savings, Investment and Net Lending Per cent of GDP

Category	Investment 1983-1990	Saving 1983-1990	Net Lending 1983-1990	Investment 1991-1998	Saving 1991-1998	Net Lending 1991-1998	Investment 2004	Saving 2004	Net Lending 2004
World	24.2	22.9	--	24.0	22.9	--	24.6	24.9	--
Industrialized Countries	22.7	22.1	-0.6	21.6	21.1	-0.5	20.7	19.4	-1.8
- US	20.2	17.5	-2.8	18.5	16.1	-2.4	19.6	13.6	-6.0
- Euro Area			0.3	20.2	20.9	0.7
- Japan	29.7	32.5	2.8	29.2	31.6	2.4	23.9	27.6	3.7
- Newly Industrialized Asia	28.0	34.3	6.2	31.8	33.8	2.0	24.9	31.3	6.4
Developing and Transition Economics	26.2	24.2	-1.9	27.5	25.4	0.4	29.2	31.5	2.3
- Africa	21.6	18.5	-3.1	20.1	16.6	-3.5	21.0	20.6	-0.4
- Developing Asia	28.6	25.7	-2.9	32.8	31.3	-1.6	35.5	38.2	2.7
- Middle East	23.0	17.5	-5.4	25.6	22.9	-2.6	25.4	32.0	2.7
- Latin America	20.4	19.5	-0.9	21.2	18.3	-2.8	19.8	21.0	1.2
- CIS ^a	---	---	---	16.2 ^b	24.2 ^b	8.0 ^b	21.4	29.4	8.0

Source: IMF, *World Economic Outlook 2005*, Table 43, pp. 271-273.

Developing and Transition Economies include Central and Eastern Europe and Russia;

Note: 'a': includes Russia; 'b': Denotes 1999. Data not available earlier.

As Table 4 shows, Africa is still a net borrower of funds and its overall savings rate is lower than that of the rest of the world. This is not surprising given the profound poverty that characterizes so many countries on the continent. In principle, therefore, mobilizing more savings in sub-Saharan Africa should be an important goal. However, if these savings failed to translate into domestic investment and went overseas instead, then raising the savings rate would do little for growth or for the poor. Especially in Africa, capital flight is a severe problem [Boyce and Ndikumana, 2001]. Capital management techniques, as we discuss in section 6, can help stem this capital flight.

CHALLENGE #4: CREDIT AND CAPITAL FLOWS ARE PRO-CYCLICAL

When capital flows do come into many developing countries, they are often short-term and pro-cyclical and are sometimes associated with 'sudden-stops'. These, in turn, can lead to financial crises capable of having devastating economic impacts, especially for women and the poor. [Palma, 2000; Ocampo, 2003; and Singh and Zammit, 2000]. Estimates place the average cost of a severe financial crisis at 10 per cent of GNP [Rodrik, 2006]. The threat of such destabilizing crises leads many countries to accumulate large amounts of foreign exchange reserves which are very costly to hold and could be better spent on domestic investment [McKinley, 2006].

CHALLENGE #5: ABSENCE OF LONG-TERM, 'PATIENT' CAPITAL

Short-term, unstable flows of international capital represent a more general and severe problem facing many developing countries—namely, a dearth of long-term, patient capital to support long-term investment [Stallings and Studart, 2006]. Most capital is of a highly short-term nature,

especially in the poorest countries in Africa, Asia and Latin America. As a result, long-term productive investment is extremely difficult and costly to finance.

CHALLENGE #6: INSUFFICIENT CAPITAL FOR SMALL AND MEDIUM ENTERPRISES AND POOR HOUSEHOLDS

Finally, there is a lack of capital for small and medium enterprises and the poor in most regions of the world [Stallings and Studart, 2006]. This problem flows from many of the ‘stylized facts’ described earlier: high real interest rates and interest rate spreads, misallocation of global financial resources, the short-term and pro-cyclical nature of international capital flows, and the absence of long-term, patient capital.

Pro-poor financial policies must solve many of the problems discussed here in order to succeed. In sections 4-6 of this module, we describe a range of policies that can help meet these challenges. We also survey various experiences with financial institutions and policies that have been associated with developmental finance, as well as assess their successes and failures. We will see that these policies tended to be the most successful when they satisfied several conditions:

- They had strong monitoring mechanisms in place to increase the likelihood that they could achieve their goals.
- They operated in a context of robust aggregate demand so that there was a facilitating environment for economic growth.
- They also operated in a domestic and international environment in which there was not a large degree of instability.
- They were part of a coherent overall developmental plan implemented by the government.

4 MOBILIZING AND CHANNELLING SAVINGS FOR PRO-POOR GROWTH: A CONSIDERATION OF POLICY OPTIONS⁵

Domestic financial policy in developing countries should be driven by the following objectives: the financial system should operate in the service of sustainable, stable and equitable economic growth, and it should place improvement of the living standards of the poor at the heart of its operations. The chief function of the domestic financial sector in developing countries is to provide finance in adequate quantities and at appropriate prices for public and private investments and for social expenditures that are central to a pro-poor growth agenda. Domestic financial policies that mobilize and channel domestic savings should therefore be evaluated according to the extent to which they serve these ends. Any domestic financial reforms that improve the functioning of the financial system along other dimensions (such as enhancing its liquidity and international integration) should be secondary to the primary goal of promoting pro-poor growth.

In what follows, we will see that there are numerous ways that domestic financial policy can be oriented towards a pro-poor growth agenda. Before turning to specific policies, however, there are three general points to make about all of the policy options that we present here.

First, the appropriate mix of domestic financial policies for any one country depends on its unique national conditions. Most important among these are the character and institutional structure of the national financial architecture; institutional, regulatory and administrative

capacities; and historical, political and economic conditions. Simply put: there is no single template for domestic financial policy—what is a feasible, desirable, appropriate approach to policy in one country may not work in another.

Second, in this module we discuss policy options for the domestic financial sector, for central banks, and for international capital flows separately. In practice, there is a strong element of complementarity among these three components of the overall financial environment. Indeed, the success of policy initiatives in one particular domain depends critically on the success of enabling or supporting policies in the other domains. For instance, we will see in section 5 of this module that a developmental central bank is critical to the success of many of the policies toward the domestic financial sector discussed in this section. Similarly, we will see in section 6 of this module that certain policies towards international capital flows (such as those that restrict outflows) buttress efforts to mobilize domestic savings.

There is also a complementarity between fiscal policies (see module #1) and efforts to mobilize domestic savings. For instance, fiscal policies that promote domestic savings and enhance the collection of taxes from the wealthy and from large firms (especially the foreign firms that are too often granted tax holidays) necessarily increase the available pool of resources that can be allocated towards activities that serve a pro-poor growth agenda.

Third, monitoring, performance assessment and policy dynamism are critical to the success of and political support for all of the policies discussed in sections 4-6 of this module. Evidence from many countries shows that development banks and other specialized banks, programs of direct credit allocation, lending targets, credit guarantees, loan subsidies, tax credits and state subsidies for targeted lending can all be managed and regulated effectively *if* the government and the banking sector have the ability and commitment to monitor and assess these initiatives consistently. The maintenance of transparent and consistently enforced performance targets is extremely important to ensuring that the policy measures discussed here can achieve their stated goals. The design of assessment measures and the technical ability to carry them out should be an integral part of the process of designing financial policies—these measures should not be an afterthought that is hastily patched together once policymakers have become aware of certain problems, such as the misallocation of resources.

Equally important to policy success is a commitment to dynamic, rather than static, approaches to financial policy [see Grabel, 2004; Epstein, Grabel and Jomo, 2004; and discussion in section 6 of this module]. That is, policymakers should maintain a commitment to strengthening, weakening or even phasing out financial policies when the economic environment changes in a way that renders old strategies no longer useful or viable or when the objectives of a policy have been achieved.

It is critical to acknowledge that the challenges of effectively monitoring and adjusting policies are neither greater nor lesser than the challenges associated with managing private banks and international capital flows in a volatile, liberalized environment. This is a point often overlooked by orthodox economists when they quickly reject the kinds of policies that we discuss here on the grounds that they do not have a proven track record or that developing countries have insufficient institutional capacity to manage them.

With these three considerations in mind, we will now describe a range of strategies toward the domestic financial sector that can be used to mobilize and/or allocate domestic savings in the service of a pro-poor growth agenda.

4.1 DEPOSIT INSURANCE TO ENHANCE CONFIDENCE IN THE BANKING SYSTEM

McKinley [2005] calls attention to the difficulty that banks in developing countries confront in trying to mobilize deposits. There are many reasons for this, and one of the most important of these is a lack of a properly funded deposit insurance system. There is every reason to believe that a properly funded and managed system of deposit insurance could help overcome the public's lack of confidence in the domestic banking system, and thereby contribute to an increase in the deposit base available for bank lending [McKinley, 2005, p. 24].

4.2 DIRECT CREDIT ALLOCATION AND SUBSIDIZED LENDING

There are many ways that governments can and have influenced the price and allocation of credit in accordance with their economic and social goals. Interest rate controls and programs for the direct allocation of credit from the government to key sectors and firms were central to the improvement of living standards and to the attainment of growth and industrialization goals in Japan, in most Continental European and East and Southeast Asian countries, and in Brazil during the post-WWII era [see Chang and Grabel; 2004; Stiglitz 1994; Chang, 1994; Wade, 1990]. More recently, China, Taiwan Province of China (POC) and India have all used programs for direct credit allocation successfully [see Epstein et al., 2004 for details]. All of the governments mentioned have also subsidized lending in accordance with various economic and social goals.

4.3 LENDING TARGETS AND CEILINGS, AND TAX INCENTIVES

Lending targets or tax credits can promote bank lending in support of a range of identified economic and social goals through a number of means. Government influence over loan allocation can involve the establishment of transparent lending targets that are imposed on private, quasi-private or publicly controlled banks. Today, such programs are in place in a number of countries. For instance, in India, Nepal, Pakistan and, to some extent, the Philippines, banks are required to channel significant proportions of their loan portfolios to agriculture and other sectors identified as disadvantaged.⁶ In India, all commercial banks and regional rural banks are required to lend 40 per cent of net bank credit to identified priority sectors. Within this 40 per cent target, at least 18 per cent of net bank credit must go to agricultural borrowers, 10 per cent must be extended to identified 'weaker' sectors (namely, small and marginal farmers, rural artisans and agricultural labourers), and the remaining 12 per cent must be allocated either to the previously mentioned types of borrowers or to small-scale industry. Of the lending to small-scale industry, 40 per cent must be allocated to what is termed 'tiny' industry.

The tax system can also be used to direct credit toward those projects that fall within a pro-poor growth agenda. Tax incentives can encourage banks to lend to certain types of firms or sectors, or to particular social groups, such as the poor, first-time entrepreneurs, women and ethnic minorities.

Another strategy that can be employed by governments is the establishment of ceilings on the percentage of bank loan portfolios that can support activities in 'non-priority' sectors or activities, such as securities trading, real estate or off-shore investments. For example, Taiwan POC had such a program in place from 1989 to 1995. The lending ceiling limited the ability of banks to lend to the real estate sector. This ceiling was introduced following the development of a real estate bubble that caused fears of financial instability [for details on Taiwan POC, see Epstein et al., 2004; Chin and Nordhaug, 2002]. Governments can also preclude all banks or certain types of banks from participating in non-priority sectors, such as securities trading.

4.4 SPECIALIZED LENDING INSTITUTIONS AND DEVELOPMENT BANKS

Specialized lending institutions can be established to serve particular mandates. These might include encouraging entrepreneurship among women, minorities or the poor, supporting the development of SMEs, or promoting the development of new technologies (such as those that encourage favourable environmental outcomes).⁷

Another means of ensuring the provision of finance to particular sectors or firms is through the creation of development banks with narrow mandates. Development banks can be publicly financed and managed as in Brazil, Republic of Korea, Japan and France, or can be privately financed as in the case of German industrial banks. It is also conceivable that these banks could be organized as public-private hybrids and could raise capital on international markets and even from private donors.

Development banks are the institutional counterpart of the industrial policies and public investment programs that have been critical to the success of late developing (or 'newly industrializing') countries, as the experiences of several countries suggest. We will now consider the performance of development banks in the 'developmental states' of the post-war period.

Amsden [2001] describes how many late industrializing countries developed a manufacturing base and rapidly industrialized after WWII (eventually moving into mid-level and even high-technology production) thanks to state efforts to harness the domestic financial system in order to mobilize and allocate medium- and long-term finance for industrialization. She shows that policymakers in these developmental states utilized stringent controls and monitoring mechanisms to ensure that the investment projects and firms that received finance from development banks were at the heart of the state's industrialization goals. Where development banks were most successful they were supported by developmental central banks (see section 5 of this module) and firm performance standards. The latter often involved export targets—firms that failed to meet their targets were often denied further access to subsidized loans.

Amsden argues that development banking filled the void left by the absence of other financial institutions in the post-war environment, pointing out that these banks initially invested in key infrastructure that later generated demand for local labour and inputs that created business groups and local knowledge. Furthermore, development bankers themselves learned important skills such as project appraisal in the course of their operations (*ibid.*, p. 126). It is important to note that foreign direct investment played a relatively minor role in post-war industrialization and capital formation. Instead, the state, public investment and development banks were the prime movers of the industrialization process.⁸

Development banks raised capital at home or abroad and then utilized it either to purchase equity in private or public firms or to lend to such firms at below market interest rates. The lending terms of development banks were almost always concessionary [*ibid.*, p. 132]. Effective real interest rates were often low, even negative. The public finance of development banks in many developmental states was often 'off-budget' and related to non-tax revenues. It derived from foreign sources, deposits in government-owned banks, postal savings accounts and pension funds. Especially in East Asia, these revenues often lay outside the general budget and parliamentary process, thereby strengthening the hand of professional bureaucrats, as in post-war France and Japan.

Governments in developmental states also controlled non-tax-related sources of funding, such as foreign borrowing (through loan guarantees), ownership of financial institutions and the disposal of private savings (for example, through postal savings banks) [ibid., p. 133; 135]. According to Amsden, the major weakness of development banks was not that they spent on the wrong industries, but that, in some cases, they spent too much overall. [Also see Stallings and Studart, 2006].

Finally, the state played a central role in long-term credit allocation in the post-war era, even in those parts of the world where development banks were of relatively minor importance (e.g., Malaysia, Thailand, Taiwan and Turkey) [Amsden, 2001]. In these cases, the entire banking sector in these countries was mobilized to direct long-term credit to targeted industries, thereby "acting as a surrogate development bank" [ibid., p. 129].

Mechanisms to finance public investment programs can be created through fiscal policy reforms (see Training Module #1). Public debt market reforms can also play a role in this connection, as Epstein and Heintz's [2006] work on Ghana suggests. In the case of Ghana, they suggest that the government develop longer-term public debt instruments as a way of lowering interest costs (which are high on short-term instruments) and as a means of raising funds to finance public investment. This proposal has obvious relevance outside the Ghanaian context.

4.5 CREDIT GUARANTEE SCHEMES TO REDUCE RISK PREMIA ON MEDIUM- AND LONG-TERM INVESTMENTS

Banks in developing countries are often unwilling to extend credit to medium- and long-term investments because of the perceived risks and the availability of substitute assets, such as Treasury bills, that have high returns and are less risky. One way of reducing the risk associated with these investments (and thereby encourage lending over the medium- and long-term) is to have the government guarantee a portion of the loan to support approved projects. In a UNDP-sponsored study of Ghana, Epstein and Heintz [2006] propose public underwriting of loans to lower risk premia on investments that support the objectives of employment creation and poverty reduction. Their proposal has relevance beyond this national environment, and we therefore reproduce it here.

In a credit guarantee program, the interest charged on guaranteed loans would be lower than the prevailing market rate. The appropriate level for the concessional interest rate would be a weighted average of the market rate of interest for the type of loan extended and the risk-free rate of return on government securities. At this rate of interest, the program would not place any economic burden on the banks that participated in the guarantee scheme. However, it does suggest that the lowest possible interest rate would be the prevailing rate on government securities (for a 100 per cent secured loan). Therefore, such a credit guarantee program could only lower the cost of borrowing so far. The program would therefore be more effective if paired with other strategies to reduce the average costs of borrowing throughout the economy (on the latter issue, see below).

In a credit guarantee program, borrowers would be required to supply some form of collateral, even if a large portion of the loan were guaranteed. This is an important mechanism for ensuring that loan guarantees do not create perverse incentives. The collateral requirements would be less stringent than for other types of loans. Coupled with monitoring and performance targets, the collateral requirement could reduce the perverse incentives for borrowers associated with loan guarantees (and the potential drain on public resources if the loan were to become non-performing).

4.5.1 How Can Borrowing Costs Be Lowered?

A reduction in domestic interest rates is an important part of a pro-poor growth agenda, particularly because lower interest rates can support some of the programs considered here, such as credit guarantee schemes. Certainly incomes and competition policies might be necessary were reductions in the average interest rate to raise inflation rates beyond a moderate level [Pollin et al., 2006; McKinley, 2005].

Average borrowing costs could be reduced through a number of means. We know that it would be far easier for central banks to lower their prime lending rates were programs of inflation targeting to be abandoned (see Training Module #2 and section #5 of this Module) [Pollin et al., 2006; McKinley, 2005]. The introduction or strengthening of competition policies could also address banking sector concentration, and thereby also create the possibility that average interest rates in the economy could be reduced [Epstein and Heintz, 2006; McKinley, 2005]. Enhancing the competitiveness of the process by which government debt were sold (e.g., through government auctions) could also promote reductions in average interest rates because governments would not be able to influence auction outcomes.

Interest rates on desired types of assets can be lowered through a number of means considered in this section of the module. Credit guarantees of the sort described here, asset based reserve requirements (see section 4.6) and direct subsidies or concessionary loan rates for especially desirable projects (see section 4.2) are all ways that interest rates on some types of projects can be reduced. Note that direct subsidies or concessionary loan rates can be an expensive undertaking, but there may be particular cases, such as for projects with especially large employment multipliers, where such measures may be worthwhile [McKinley, 2005, p. 23; Pollin et al., 2006].

4.6 VARIABLE ASSET-BASED RESERVE REQUIREMENTS

Another means to ensure that the domestic financial system serves the objectives discussed above is through a system of variable asset-based reserve requirements for financial firms. A system of variable asset-based reserve requirements has three chief components: 1) all financial firms in the economy are required to hold differential reserves against different types of assets in their portfolio, such as stocks, bonds, mortgage, consumer, or small business loans; 2) financial regulators establish and manipulate the required reserve ratio against each type of asset based on government objectives vis-à-vis encouraging certain types of investments (for example, in employment-intensive sectors) and their evaluation of a number of factors, such as the risk associated with that asset and market conditions; and 3) required reserves are held in non-interest bearing deposit accounts at the central bank.

Variable asset-based reserves provide regulators with a means to encourage financial institutions to hold certain types of assets by reducing the ratio of required reserves that must be held against them, and thereby lowering the cost of holding certain assets (and vice versa). Variable asset-based reserves provide regulators with a means to target sectoral imbalances involving over—investment in some sectors and under—investment in others, as well as with a means to use the financial system in the service of economic and social goals.

A system of variable asset-based reserves can also reduce the risk of financial crisis through two channels. Regulators can use the asset-based reserve requirements to deflate bubbles in particular asset markets as they emerge and before they culminate in financial crises. The system also functions as an automatic stabilizer because it requires financial institutions to deposit additional reserve holdings whenever asset values rise or whenever new types of assets are created.

4.7 EMPLOYMENT-ORIENTED FINANCIAL POLICIES: DESCRIPTION OF A PLAN DEVELOPED FOR SOUTH AFRICA

As a concrete example of some of these policies, we will briefly describe a set of financial market interventions developed by Pollin, et. al. [2006]. They propose a set of employment-oriented financial policies capable of contributing to the South African government's goal of reducing unemployment by half in ten years. This plan puts forward a set of credit allocation policies designed to target employment-generating projects. The proposal has clear relevance outside of the South African context. For this reason, we describe it in some detail below.

The plan outlines three main policy tools to channel credit to targeted industries at concessionary rates with the goal of generating employment. A first policy tool is a major expansion in the lending activity and developmental focus of the country's currently existing development banks. The Industrial Development Corporation is South Africa's largest development bank. Its 2005 Annual Report reported that through its lending activity over 2004-05 it anticipated creating 16,700 jobs. However, this is far too modest a contribution for such an important institution, given that the official statistic of 4.3 million unemployed people in 2005 is 257 times larger than this figure of 16,700. The capitalization of these banks therefore needs to increase, so they should be allowed to assume a higher level of risk on behalf of an employment-targeted growth agenda.

A second policy tool for channelling credit is the establishment of asset reserve requirements for private banks and other financial institutions (see section 4.6). For example, the plan stipulates that banks should hold 25 per cent of their loan portfolio in designated employment-generating activities. If the subsidized activities accounted for less than 25 per cent of a bank's total loan portfolio, the bank would have to cover this gap by holding cash. Features of this proposal are comparable to the system of 'prescribed assets' that operated in South Africa from 1956 to 1989. However, the Pollin et al. [2006] plan proposes more flexible measures (for example, it allows banks that hold more than 25 per cent of their loans in subsidized activities to sell permits to institutions whose targeted industries account for below the 25 per cent minimum of subsidized loans).

A third tool for channelling credit is a major expansion of the government's system of loan guarantees. The South African government currently has a loan guarantee program but it is far too small. Under the government's current loan guarantee program, the accruals on its contingent liabilities—i.e., the amounts that the government actually pays when loans default—has been a trivial cost, amounting, on average, to 1/100 of one per cent or less over the recent past. The plan described here proposes the following program instead. The government underwrites about R40 billion per year in loans, i.e., a figure approximately equal to 25 per cent of fixed capital formation as of 2004. The plan assumes a default rate on these loans of 15 per cent and loan guarantees covering 75 per cent of the principal on defaulted debts. Within this scenario, it follows that the accruals to the government would amount to R4.5 billion/year (i.e., R40 billion x .15 x .75). This is a crucial result. It shows that the government has the capacity to underwrite a major loan guarantee program, roughly equivalent to 25 per cent of productive investment in the economy, with a financial commitment of no more than 1-2 per cent of its fiscal budget.

These three parts of the credit allocation plan amount to having the financial sector subsidize credit for certain borrowers. Three key issues arise in this connection: 1) who should receive the subsidized credit? 2) which institutions should allocate the credit?; and 3) what monitoring should be put in place to ensure that the funds are well spent and achieve their desired goals, namely, facilitating pro-poor growth?

Who should receive subsidized credit? The fundamental purpose of the expanded credit allocation policies is to facilitate a program of rapid employment growth. Subsidized credit should be directed toward viable businesses that will expand employment.

The plan proposes that businesses, including co-operatives and non-profit organizations, be eligible for credit based on two criteria. The first is 'social priority lending' for small-scale activities. Three areas that fall under this heading are: land reform and rural development, which would help generate and build assets for the rural poor; the promotion of SMEs, a basic challenge for many developing countries and one that should be part of any pro-poor financial policy [Stallings and Studart, 2006]; and the promotion of collectives and other alternative ownership forms, since for the poor, new and alternative ownership forms can be crucial to individual efforts to leave poverty behind by generating asset ownership and employment.

The second criterion stipulates that a firm that does not meet the 'social priority' criterion will be eligible for concessionary loans if it can demonstrate that its project will produce large positive employment effects. Thus, to apply for a loan under this program, a firm would have to provide an employment impact statement demonstrating the overall number of jobs to be created by its investment. The employment impact statement should include both the direct and indirect job effects of the project to be financed by the loan.

Who would provide the loans? According to this plan, both public and private financial institutions would provide these loans. There are currently a number of development banks and public and quasi-public financial institutions in South Africa. One of the largest is the Industrial Development Corporation, which has committed itself to expanding its developmental role in general, including its role in job creation [Mondi, 2006]. The plan would involve expanding the role of the development banks, such as the Industrial Development Corporation, in employment creation, as well as mobilizing the private financial system through loan guarantees and asset reserve requirements.

The plan would also encourage small-scale banking, a so-called second tier of institutions, to enter the market, perhaps with the support of the Reserve Bank of South Africa (see section 5 of this module). Development banks could encourage this second tier banking system by investing in the creation and expansion of such institutions.

The program of loan guarantees would underwrite an expansion of R40 billion and aim for a default rate of 15 per cent, while the government would guarantee 75 per cent of the principal. The cost would be about R4.5 billion/year, which comes to about 1.2 per cent of government spending. This is significant, but the goal would be to generate thousands of jobs that would expand both the economy and government revenue.

An advantage of this plan is that it would be profitable to private lenders as well as help to expand credit and employment. However, to guarantee its efficacy, careful monitoring systems would have to be set up. The plan proposes that these include a series of employment targets, escrow accounts, rewards for whistle blowers who report corruption, and penalties for those who do not meet the targets (readers are encouraged to see Pollin et al. [2006] for details on measures to reduce corruption, fraud and inefficiency since these may be relevant in some contexts).

Those receiving priority lending would be required to deposit part of the loan in escrow accounts, with the balance to be returned on repayment of the loan. The size of the escrow required would be inversely related to the size of the subsidy the government chose to grant

to the borrower. In addition to setting the size of the escrow account, the lender would engage in normal monitoring of the loan. For large-scale employment loans (that is, granted to firms that produced employment impact statements), monitoring would be oriented towards assuring that the firms fulfilled their employment creation promises.

4.8 IMPROVEMENT OF BUSINESS SERVICES AND INFORMATION RESOURCES TO FACILITATE LENDING TO SMEs⁹

The lack of skills, technical support and adequate information among SMEs limits the willingness of banks to lend to such enterprises. Thus, there is a need to develop capacity for technical assistance, particularly in terms of managing the risks faced by SMEs. For example, legislation could be enacted requiring all banks to have an effectively functioning desk to deal with SME applications. Specific parameters would be set to evaluate whether banks were complying with the regulations. Similarly, government could spearhead policies in support of the establishment of credit bureaux to collect and maintain information on potential borrowers. These credit bureaux could be designed to deal specifically with the information problems associated with small-scale credit applications. The credit bureaux could be charged with facilitating financial services between lenders and potential borrowers.

4.9 FORGING LINKAGES BETWEEN INFORMAL AND FORMAL FINANCIAL INSTITUTIONS¹⁰

In some countries, informal financial institutions presently fill important needs—namely, they provide credit (though often at high cost) to rural communities and to small businesses. The informal financial sector may have an advantage over the formal financial sector in making small loans. However, the lending capacity of the informal sector is clearly limited because its deposit base is necessarily small [Selvavinayagam, 1995]. Policymakers in developing countries have two options when it comes to the informal financial sector: they can either increase the ability of informal financial institutions to perform their traditional functions, or they can enhance the ability of the state and/or the formal financial sector to mobilize and channel capital to the underserved rural communities and small businesses. The latter strategy is clearly preferable, but we appreciate that the former may be more feasible in some contexts, especially in the short run. For this pragmatic reason, we will now describe some strategies for enhancing the performance of the informal financial sector.

By way of background, we should acknowledge that informal financial institutions have diverse organizational structures and that they interact with formal institutions in a variety of ways. In some cases, informal financial institutions closely resemble formal institutions with regard to their scale of operation and average loan size. Interestingly, large-scale informal financial institutions have lent substantial sums to medium-sized enterprises in Taiwan POC [Tang, 1995]. These informal financial institutions have been encouraged by the government [Biggs, 1991; Pickbourn, 2006].

In some contexts, informal financial institutions may compete with or substitute for the services provided by formal financial institutions.¹¹ In other cases, complementarities between informal and formal financial institutions exist. For example, formal financial institutions may lend informally mobilized deposits or informal lenders may act as intermediaries for formal institutions [Aryeetey 2003]. In still other cases, there is little—if any—interaction between formal and informal financial institutions due to the fragmented nature of financial markets in some developing countries [Aryeetey, 1998; Selvavinayagam, 1995].

Policymakers who choose to enhance the performance of the informal financial sector would do well to develop complementary linkages between informal and formal institutions. For instance, relationships could be built between formal banks and rotating savings and credit associations to facilitate group savings and lending for informal and small enterprise development [Amoako-Tuffour, 2002; Aryeetey, 1998]. Aryeetey [1998] suggests that formal banks could encourage informal institutions to place their deposits with them by offering a preferential deposit interest rate and by waiving fees on their demand deposits. In addition, he suggests that agency-type relationships could be developed among well-established informal, semi-formal (e.g., NGOs and microfinance) institutions and formal lenders. In this scenario, formal banks would channel some of their funds to semi-formal and informal lenders for lending to small borrowers.

Aryeetey rightly suggests that only recognizable, well-established informal lenders should be involved in such a program, namely lending associations, cooperatives and unions. He also suggests that other mechanisms for forging linkages between formal and informal financial institutions might involve creating tax incentives to compensate formal banks for the costs and risks of developing small borrower portfolios (i.e., by offering tax relief to formal banks that allocate credit through semi-formal and informal agents) and modifying certain restrictions as to the types of assets that formal financial institutions can hold to encourage them to invest in semi-formal institutions.

Note that developing these new institutional relationships between formal and informal financial institutions would require a broader regulatory structure for suppliers of credit, one that would specifically incorporate a role for informal credit institutions in those countries where such institutions are currently playing important roles. At this point, the lack of prudential regulation of informal financial institutions may hinder the willingness of formal institutions to increase their ties with informal institutions. It would therefore be important for policymakers to develop an appropriate regulatory framework for informal financial institutions, particularly in those cases where they have chosen to increase the linkages between formal and informal institutions.

There is much research to be done on the issue of regulating informal institutions. Preliminary work along these lines appears in Lapenu [2002] and especially in Daley-Harris [2002, ch. 6]. The latter argues that it is important to establish industry norms and standards for unregulated microfinance institutions (MFIs), as well as to develop appropriate means to reinforce these performance standards. Daley-Harris [2002] proposes specific performance indicators and norms that can be used by regulators for monitoring the microfinance portfolios and organizational capabilities of regulated banks and MFIs. Aryeetey [1998] suggests a three-tiered approach to regulation and supervision of the informal sector: formal banks lend to credible, semi-formal agents who then link up with informal lenders; rural/small borrowers receive loans directly from informal agents; and semi-formal institutions can then be the agencies responsible for the regulation of smaller, informal units.

4.10 ENHANCING THE ABILITY OF MICRO FINANCE INSTITUTIONS (MFIs) TO SERVE BORROWERS

Much has been written over the last decade about the remarkable growth of diverse types of MFIs across all regions of the developing world [e.g., Versluysen, 1999; Daley-Harris, 2005, 2002; Zeller and Meyer, 2002]. Although the structure and operating practices of MFIs remain heterogeneous, these institutions generally share a commitment to serving those social groups and small-scale businesses that are not served by the formal financial sector. The lending of MFIs can therefore

promote some degree of employment creation and poverty alleviation by providing opportunities for business activity by those groups (such as women) and to those areas of the country (especially rural areas) that normally face severe credit constraints.

However, it should be obvious that MFIs are not the development panacea that many enthusiasts suggest. Indeed, Rahman [1999], Grosh and Somolekae [1996], and Christensen [1993] raise issues that complicate the generally sanguine view of MFIs, while essays in Zeller and Meyer [2002] also offer a more nuanced empirical view of MFIs than one generally finds in the literature. It is clear that MFIs cannot play a central role in promoting pro-poor growth, nor are they an appropriate institutional form to resolve problems of savings mobilization or allocation on the macroeconomic level.

Nevertheless, MFIs are a part of the financial landscape in many developing countries, and they are supported by many external donors. Thus, it is reasonable to consider how the potential of MFIs to contribute to savings allocation and mobilization can be enhanced by the supportive actions of developmental central banks and/or external actors. In what follows, we briefly survey the most successful efforts to provide support to MFIs.

Central banks specifically support MFIs through credit guarantees and insurance, participation in their capitalization, management, and establishment of priority sector lending requirements, differential interest rates, preferential rediscount rates and facilities that target credit/deposit ratios for rural bank branches.¹² External support has been crucial to the success of almost all MFIs. While central banks have generally not provided direct financial support to MFIs that are not licensed financial institutions, there are a number of important exceptions. In Bangladesh, for example, the central bank provided support to the Grameen Bank from as early as 1979, before it was established as a specialized development bank in 1983. The central bank also supported the bank with lines of credit.

Central banks may also operate as 'second-tier' institutions that channel funds to individual MFIs. In Nepal, for example, the central bank administers the Rural Self-Reliance Fund, which provided wholesale funds to MFIs for lending to final borrowers. In India, the National Bank for Agriculture and Rural Development was established by the central bank as an apex body for rural credit. It provides a small amount of revolving fund assistance to nonbank MFIs, with funding obtained from the Swiss Agency for Development and Cooperation.

In Indonesia, the central bank disburses funds to the provincial government, commercial banks and rural banks for lending to small financial institutions and micro-entrepreneurs under a micro-credit project initiated with support from the Asian Development Bank. These banks have been highly successful in developing appropriate products and processes for reaching micro-entrepreneurs, though interest rates are high at around 2-4 per cent per month. Like the Grameen Bank, they have enjoyed repayment rates of over 95 per cent.

The issue of appropriate regulation for MFIs cannot be ignored, and there is much research that needs to be done in this area. Based on experiences in Ghana and the Philippines, Gallardo [2001] describes a tiered regulatory structure for MFIs and has identified threshold levels of intermediation that trigger the need for external regulation of their activities. External regulation is not called for where MFIs (and informal lenders) do not access funds beyond members' savings. However, a higher standard of regulation is called for when MFIs access funds from external sources. In such cases, the standard registration procedures that apply to formal financial institutions (involving, for instance, filing documents regarding the establishment and the governance structure of the institution) should apply to all MFIs.

An even higher level of regulation applies to institutions engaged in financial intermediation that does not include retail deposit-taking activities. These institutions should be monitored through standard periodic reports. Even more stringent regulation should apply to all limited-license banks and non-bank MFIs, permitting them to take deposits from the general public that are limited to a multiple of the institution's total qualifying capital. Such institutions may need to comply with higher capital adequacy guidelines and restrictions on their services and operations. The highest level of regulation applies to licensed banks that are permitted to mobilize retail deposits from the general public. These institutions should be subject to full offsite and onsite supervision, licensing requirements and full prudential supervision by the regulatory authorities.

5 CENTRAL BANKS AS AGENTS OF PRO-POOR GROWTH: A CONSIDERATION OF POLICY OPTIONS

As mentioned in section 4.10, central banks can play a role in supporting developmental lending by MFI's and other institutions serving social needs. In the last several decades, however, this 'developmental' financial role for central banks has *not* been the norm. In fact, during the last decade, central banks in developing countries have increasingly adopted approaches to monetary policy that focus on lowering the rate of inflation, with little regard to their impact on 'real factors' such as poverty, employment, investment or economic growth. Among these approaches, 'inflation targeting' is the most prominent [Saad Filho, 2006]. At the same time, they have eschewed the broad range of tools of central bank policy so widely used by developed country and developing country central banks for allocating credit to social priority sectors and managing the international flows of capital. Instead, most central banks now focus on a narrow range of stabilization goals, using a narrow range of instruments, primarily short-term interest rates.

Following this strategy, central banks attempt to hit a target range for inflation while mostly ignoring the impact of monetary policy on other economic variables. By 2005, more than 19 countries had adopted inflation targeting and more countries are considering doing so [IMF, 2005]. Even where countries do not implement *formal* inflation targeting, many of them—under pressure from the IMF and other organizations—still orient policy almost exclusively to fighting inflation. In many countries, inflation targeting has generated significant costs—slow growth, sluggish employment generation and high real interest rates—while yielding, at most, minor benefits. Among the greatest disappointments for proponents of inflation targeting has been its apparent inability to reduce the so-called *sacrifice ratio*, the unemployment costs of fighting inflation. [Saad Filho, 2006].

Inflation targeting is also typically accompanied by the absence of credit promotion and allocation policies by the central bank. In line with standard orthodox approaches, the central bank has eschewed 'developmental central banking' in favour of focusing exclusively on 'stabilization' as the goal of economic policy. This focus on fighting inflation and achieving stabilization, to the exclusion of addressing other problems, is particularly puzzling in light of the well-known evidence indicating that moderate inflation (10-15 per cent) has no negative consequences on important real variables [Bruno and Easterly, 1998; Zhu and Pollin, 2005].¹³ By contrast, the costs of large-scale unemployment and slow growth are high and well understood. For example, South Africa, where the unemployment rate is above 40 per cent, seems singularly ill-suited for such a policy, yet the South African Reserve Bank is an enthusiastic supporter of inflation targeting.

Hence, alternatives to this destructive monetary policy must be developed and promoted. Indeed, a central component of any macroeconomic policy aimed at tackling the ills of poverty, high unemployment and slow economic growth in developing countries must rest on a feasible

and efficient framework for conducting monetary policy oriented toward these goals while, to be sure, keeping inflation from escalating beyond a moderate level and holding other problems in check. Along these lines, central banks must play a more pro-poor developmental role. This developmental role has two components, one with respect to monetary policy and the other with respect to sectoral and credit allocation policies.

Monetary Policy: Within a *real targeting* framework for central bank policy, central banks first choose a real target that is appropriate for that particular country—normally poverty levels, employment growth, investment or real economic growth—and then choose a set of monetary policy instruments to achieve that target. Central to this strategy is the recognition that in order to achieve the chosen target, there will normally be other economic constraints that must be confronted, including, most notably, inflation and balance of payments or exchange rate constraints [Pollin, 1998]. In this situation, the central bank will normally have to hit multiple targets and constraints. Therefore, taking into account the classic Tinbergen analysis, it will need to implement several monetary policy tools, including perhaps, some new ones.

Sectoral Policy: With respect to sectoral policies, central banks can support institutions facilitating the allocation of credit by the government and financial institutions for sustainable growth and employment generation as well as the accumulation of productive assets by the poor. We consider monetary and sectoral policies in sections 5.1 and 5.2, respectively.

As we will see below, changes in interest rates and other standard monetary tools are important to lowering the cost of credit and expanding aggregate demand, as well as helping to moderate inflation. Training Module #2 discusses this component in detail. However, for central banks to have a truly significant impact on generating employment and reducing poverty, in many cases they have to play a crucial developmental role and interact with the financial sector. A discussion of this ‘developmental financial role’ of central banks will be a key focus of our discussion here.

First, we provide a brief overview of the overall central bank framework that can be conducive to pro-poor growth.

5.1 MONETARY POLICY: A REAL TARGETING APPROACH

This *real targeting* framework has a number of important advantages.

1. First and foremost, it places front and centre the economic variables that have the most immediate and clearest association with social welfare. The central bank will be forced to identify this target and then reach it, and if it fails to do so, explain why it failed and how it will improve in the next period.
2. Given the public pressure to reach this target, the central bank will have significant incentives to invest in research and other activities to improve its understanding and develop tools to reach this real target.
3. Given that it will need to reach this target amid other constraints, it will need to develop new tools of monetary policy. For example, if a central bank must hit an employment target subject to an inflation and balance of payments constraint, then—in addition to interest rate policy—it might explore asset allocation strategies to encourage banks to lend more to high employment-generating uses and capital control techniques to manage balance of payments problems [Pollin, 1998; Epstein, Grabel and Jomo, 2004].

4. A real targeting approach lends itself naturally to a more democratic, transparent and accountable central bank policy that serves the genuine needs of the majority of countries' citizens, rather than those of a minority that typically benefits from the combination of high real interest rates, low inflation and slower growth.
5. The framework is much more conducive to tailoring monetary policy to the specific needs of different countries. For example, if a country has a particular problem with generating good jobs for women or more jobs in a particular region of the country, the real targeting approach is better suited to target such employment objectives (along with more employment generally) and devise instruments to achieve them.

In short, the *real targeting approach* to monetary policy is likely to be more relevant, flexible and effective than inflation targeting.

5.1.1 Employment Targeting and Central Bank Policy: An Example

An alternative targeting approach would target 'real' variables that contribute directly to the economic welfare of the majority of the country's residents. The advantage of a targeting approach is that it requires the central bank to identify its goals, makes transparent whether it is reaching that goal, and therefore *potentially* increases the accountability of the central bank to the general public. Of course, to make accountability a reality, additional political structures must be in place as well. We turn to this issue briefly at the end of this Module.

Which real variable should be targeted? This will obviously depend on the particular circumstances of the country involved. For some countries with a very large unemployment or underemployment problem, such as South Africa, *employment targeting* is a good candidate. In other cases, investment growth or real GDP growth would be more appropriate. Unlike the claims made by proponents of *inflation targeting*, the real targeting approach recognizes that one size does not necessarily fit all. Still, employment targeting is a good example because creating gainful employment must be a crucial element in pro-poor financial policy.

In this section we have elaborated on one example, namely, an *employment targeting* approach to monetary policy. Other examples, such as investment or real GDP targeting, would share many of the components described here.

5.1.2 Employment Targeting

With employment targeting, central banks would choose, or be given by the democratic authorities, an employment, employment growth or unemployment rate target. The central bank would be required to devise means (i.e., instruments) for achieving that target. If it failed to achieve the target during the allotted period, it would be required to explain why the target was not achieved, as well as to develop mechanisms for achieving the employment target in the next period. Implemented in this way, targeting contributes to central bank transparency and accountability, thus taking an important leaf from the 'inflation targeting' book.

As mentioned earlier, the evidence indicates that if inflation reaches high enough levels, it can create significant economic and social costs. Hence, no central bank can entirely ignore inflation. In the employment targeting approach, therefore, the central bank must achieve its employment target *subject to an inflation constraint*. What the inflation constraint is should depend on the particular circumstances of the country involved. Whatever the level, as long as the constraint is

binding or could be binding in a given period, it means that the central bank will essentially have two targets—employment and inflation. And as Jan Tinbergen famously put it, policy makers need as many independent instruments as they have independent targets.

Central banks used to have many tools of monetary policy (of which we will speak more below). However, with the rise of neo-liberalism, including financial liberalization and the elimination of capital controls in many countries, most central banks have dramatically reduced the number of independent monetary tools they use, often to only one, namely, a short-term interest rate. This tool alone will not generally be sufficient to both reach an employment target and satisfy an inflation constraint. Hence, the central bank will have to develop new tools (or dust off old ones) in order to implement this policy. However, the need for the central bank to learn and innovate will most likely go far beyond this level for a simple yet profound reason: most central banks know very little about how to generate employment.

The reasons for this need are many, but the most important is quite simple: for many years now, most central banks have not had to worry about generating employment because they have been pressured to be concerned only about inflation (or the exchange rate). As a result, central banks (and associated economic researchers the world over) have devoted millions of dollars and countless hours to economic analysis and modelling to figure out the relationship between monetary policy and inflation, while spending virtually nothing on discovering the relationship between monetary policy and employment generation. Hence, not only will the central bank have to develop new instruments because it has more targets than instruments; but it will also have to develop new instruments because the target is 'new' and unfamiliar.

Research economists at the central bank will need to start conducting research on how to use monetary tools to generate more employment; they will have to consult with business, labour, organizations from the 'informal economy', maybe even NGOs (to say nothing of the labour ministries in their own government), to try to develop approaches to generating more employment. This re-orientation in research, and even a change in the culture of the central bank, could be one of the most important and long-lasting results of the re-definition of the central bank target.

As central banks learn more about how to use monetary policy to increase employment, and as they develop new tools to reach this target subject to an inflation constraint, they might discover that they are *re-inventing* tools that were part of the standard central bank tool kit in the developing world in the 1950s, 1960s and 1970s: credit allocation policies; the provision of support to development banks; and regulations in support of development lending (see below). For the most part, policies such as these that were largely eliminated in the 1990s—sometimes for good reason, sometimes not—will be re-discovered, modernized and improved upon.

5.1.3 Complementary Institutions and Additional Considerations

Because a more expansionary monetary policy *might* lead to other constraints, a central bank oriented towards increasing employment is likely to require complementary policies to be successful. These problems might include excessive inflation and capital flight. In addition, further structural changes would likely be necessary to make central bank policy truly accountable.

Inflation: The monetarist view that inflation is always and everywhere a monetary phenomenon is false [Saad Filho, 2006]. More generally, excessive inflation is not likely to be a prominent problem resulting from an employment targeting approach, as long as other economic policies of the government, including fiscal policy, are responsible and as long as the economy is not subject to excessive *external* shocks. However, excessive inflation may rear its ugly head on

occasion and economic policy must be prepared to deal with it. We have already discussed monetary policy tools to limit inflation. As the central bank develops new tools to enhance employment growth, it can, if necessary, use traditional monetary policy tools such as short-term interest rates, to satisfy its inflation constraint. In some cases, when using interest rates to fight inflation without interfering with the employment growth target may not be feasible, the central bank may need to consider other options, such as temporary incomes policies. The combination of policies required will vary depending on the country and the situation.

Capital flight: Foreign and domestic investors might speculate against the central bank policy, leading to capital flight, or more often, downward pressure on exchange rates and foreign exchange reserves. Capital management techniques, such as capital controls, might be necessary to insulate the economy from such speculative flows. As Epstein, Grabel and Jomo [2004] show, countries successfully use a variety of such techniques to manage their economies. (See section 6 for a discussion of these policies).

5.1.4 Possible Objections

Some will raise objections to the employment targeting approach specifically or to the real targeting approach more generally. The most common objection likely to come from mainstream economists is that monetary policy is incapable of affecting real variables, at least in the 'long run'. To adequately address this objection would require a separate paper, but we would like to mention a few key points on the theoretical and empirical side. On the theoretical side, the notion that monetary policy cannot affect real variables is based on an incoherent Walrasian macroeconomic model, common to orthodox macroeconomics, which assumes away problems of uncertainty and unemployment. In Marxian, Keynesian, Kaleckian, Post-Keynesian and even New-Keynesian approaches, there are strong reasons to believe that monetary policy can have long-term, real effects. On the empirical side, a vast literature supplies strong evidence that monetary policy has real effects.

Additionally, some will argue that developmentalist central banks could be captured by 'special interests' leading to 'corruption' and 'rent seeking'. While it is true that any government institution that can allocate resources may implement corrupt policies, this is not a unique attribute of state-based policies. Private corporations can also be purveyors of corrupt practices, as the multiple cases of massive fraud in Enron and many other companies have demonstrated. The challenge of dealing with corruption involves creating monitoring, transparency and accountability mechanisms applicable to all institutions. These are mechanisms as applicable to private corporations and the market as to the state.

5.2 SECTORAL POLICIES USED BY DEVELOPMENTAL CENTRAL BANKS

Monetary policy has typically been only one component of central bank policy. Using central banks to promote sectoral and industrial development, as well as to achieve government goals to raise the incomes and wealth of sectors of society, has also been important in the history of central banking. Such policies and institutional attributes of central banks have often been termed the 'developmental' role of central banks [Epstein, 2006; Asian Development Bank, 2000]. Although this developmental role has now fallen out of favour in policy circles, it has not only been very important historically, but also continues to be used to good effect in some countries [ADB, 2000; Epstein, 2006; Stallings and Studart, 2006].

This developmental role is a key component of monetary policy used for pro-poor growth. Moreover, since the major mechanism by which central banks have engaged in this policy is through their regulation of and interaction with the financial sector, this topic is central to our discussion of financial policies, even though it is located falls at the intersection between financial policy and central bank policy.

Historically, the role of central banks as agents of pro-poor development policy has varied from country to country. Using country examples from Amsden [2001], one can see that in India and China, for example, central banks played a crucial role as part of the planning apparatus and were key players in the allocation of medium- and long-term credit to industrial sectors. In Mexico and Thailand, their role was less important. In Brazil and Republic of Korea, the role of central banks occupies a middle ground between those of the other two groups. In short, while not all developing-country central banks have played a developmental role, in many they have done so quite successfully.

5.2.1 India and China¹⁴

Mr. P.C. Bhattacharyya, a former governor of the Reserve Bank of India (1962-1967), describes the role of central banking in India in the 1960s:

“India has consciously chosen a policy of planned economic development... The traditional objective of a central bank is the maintenance of price and exchange stability. However, this is but a means to achieve economic progress rather than an end in itself. In the context of the developing countries, these objectives... have to be fitted into the broader and more compelling urge for furthering economic growth... A country must have an appropriate degree of monetary expansion to meet the increasing requirements of a growing economy... The aim of a central bank in a developing country has, therefore, to be the adoption of adequate policies which aim at bringing about an appropriate degree of monetary expansion along with price and exchange stability... Further, monetary policy in such a country has also to provide for mobilization of resources to the maximum possible extent, as well as provide for the most efficient investment of the same for purposes of development.” [Bhattacharyya, 1971, pp. 1-2].

This monetary manifesto provides a stark contrast with that of the orthodox central bank, but does not seem that far different from the post-war practices of France, Belgium, Italy and Japan. (See Box 1).

Bhattacharyya emphasizes that monetary policy is only one part of economic policy and that, as a result, the central bank cannot be an entity unto itself and independent from the government [p. 15], a statement from a central banker that would shock today’s promoters of the orthodox recipe. Bhattacharyya further notes that direct instruments of monetary control have an important place in the tool kit of monetary policy: they can protect important sectors from credit tightening and allow for more direct monitoring of credit use [ibid., p. 14]. This is a view of monetary policy that is similar to those taken by French and Japanese central bankers.

As in the case of post-war European countries, India deployed a broad set of capital and exchange controls, and initially, controls over current account transactions as well. These complemented the mobilization and credit allocation techniques employed by the Reserve Bank and associated institutions. Bhattacharyya further notes that price and exchange rate stability cannot be ignored, but are part of the fundamental development process [ibid., p. 15].

Since the 1970s, India has been engaged in a process of financial liberalization. There have been several reforms of the banking and financial sectors, liberalization of interest rates and exchange controls and external financial liberalization as well. While elements of the old regime still exist, the context within which they operate has been radically altered [Saez, 2004]. The recent increase in economic growth in India has led some observers to hold liberalization and globalization to be responsible. Observers who agree with Amsden would suggest that it was during the post-war years of planning and credit mobilization and allocation, of which the Reserve Bank of India was a key part, that the foundation for recent growth was laid.

BOX 1

India

At the time of independence, India faced serious gaps in institutional structures for the mobilization of savings and investment. The banking system was mostly urban and short-term oriented, providing mostly working capital of a short-term nature [ibid., p. 3]. The stock market was the mechanism for raising long-term capital, but, like most stock markets, rationed out new firms. Thus, “it was only natural that the Reserve Bank of India... turned its attention at the very outset, to the development of various types of new institutional facilities to fill in the gaps. This became one of its main roles in pursuance of the broader objective of the promotional aspect of central banking policy” [ibid., p. 3]. The Reserve Bank established agricultural co-operative banks to help raise funds and provide technical assistance; in the industrial field, the Reserve Bank contributed to setting up the Industrial Finance Corporation of India, which was intended to supply the long-term capital needs of industry; the Reserve Bank also contributed substantially to the capital structures of various State Finance Corporations, which were supposed to support the financial needs of the small industrial sector. In 1964, it also set up the Industrial Development Bank of India as a wholly-owned subsidiary of the Reserve Bank to “function at the apex of an integrated structure of industrial finance as well as to provide resources for large-sized projects of industrial development...” [ibid., p. 5]. The Reserve Bank also promoted branch banking to mobilize savings and developed a system of industrial subsidies and preferences for targeted industries [ibid., pp. 6-8].

In China, until recently, the central bank was entirely subsumed into the state planning apparatus. The banking industry has been entirely state-owned since the revolution and is highly concentrated. The Chinese economy has been characterized by exchange and capital controls, as well as strong controls over interest rates and financial markets [Saez, 2004; Epstein et. al., 2005a]. Since the late 1970s, however, the system has been undergoing steady reforms along with the increased role of markets, private investment and foreign investment in the Chinese economy. (See Box 2).

Maintaining a low value of the exchange rate has been a crucial component of China’s development strategy and, in turn, capital and exchange controls have been a crucial component of that strategy. More recently, as interest rates, financial markets and capital controls have become more liberalized, the People’s Bank of China has begun to take on more traditional macroeconomic roles typical of ‘modern’ central banks. Still, it relies heavily on credit controls to conduct monetary policy, as it attempts to keep the Renminbi at an undervalued level for purposes of export promotion. The central bank’s management of these exchange controls has been amongst its most important developmental contributions in the last several decades.

BOX 2

China

From 1949 until the late 1970s, China was dominated by one bank: the People's Bank of China (PBOC). Its role was to help mobilize and allocate savings in accordance with the state plan. In the late 1970s the government started to reform the banking system. By the early 1980s the PBOC had been separated from the Ministry of Finance and its monopoly position had been ended. Eventually, four major commercial banks were created, all state-owned. Today, competing with the four state banks is a second tier of state-owned commercial banks. A third tier includes shareholding smaller regional banks, many of which were established as part of the special economic zones that led the economic reforms of the 1980s and early 1990s. In addition, since 1994, there have been three policy banks: the State Development Bank, the Export Import Bank and the Agriculture Development Bank. These banks handle policy-related lending associated with government plans. In addition to these banks, China has a series of urban and rural cooperative banks [Saez, ch. 15]. Finally, there is a series of non-bank financial institutions, including insurance agencies, credit unions and savings and loan associations. The presence of private and foreign banking in China is still marginal [Saez, p. 31].

One of the salient features of Chinese banking has been its close association with state-owned enterprises (SOEs). This has now become a source of significant banking problems due to the large number of non-performing loans connected with these SOEs. Among the major issues facing the financial sector is the management of these non-performing loans and the reform of the SOEs. The interpretation of these loans and the role of SOEs in China's development are highly contested. On the one hand, some argue that these loans indicate large-scale waste, inefficiency and corruption. Li argues, on the other hand, that the SOEs have been much more efficient than is generally realized and have played a significant role in China's industrial development and helped to stabilize aggregate demand. Given China's phenomenal industrial success and the large role of SOEs in the Chinese economy, it would be hard to make a case that they have played no role in China's stunning development.

The Chinese Central Bank was created out of the People's Bank of China (PBOC) in 1983. The PBOC acted primarily as an agent of the government's plan and did not exert a significant independent effect on policy. Consequently, the Central Bank is best seen as a supporter of the overall plan and of the credit allocation accompanying China's post-war growth, taking into account the strengths as well as the weaknesses of those developments.

5.2.2 The Republic of Korea and Brazil¹⁵

Republic of Korea and Brazil both had central banks that were tied to the requirements of government and the requirements of industry. (See Boxes 3 and 4).

BOX 3

Republic of Korea

As we saw in our discussion of Amsden's work, crucial to Republic of Korea's post-war success as one of the "rest" was a strong planning and control mechanism combined with institutions for channelling long-term resources to targeted infrastructure and productive industrial uses. As part of this mechanism, the Government retained strong control over the financial system, particularly in the period 1961-1979 [Nembhard, 1996, p. 90]. As one economist put it, "except in times of war, only a few nations have used policies of selective credit control as widely and thoroughly as has Korea." [quoted in Nembhard, p. 91]. The Government used the banking system to channel credit by setting low interest rates on loans to targeted borrowers and by directing loans to particular enterprises. Amsden emphasized that monitoring and performance requirements were associated with these loans.

The government used ‘policy loans’ to direct lending for preferred purposes. Lending rates and lending conditions were strictly controlled according to the type of preferential fund. This allowed the Government to effectively ration credit for certain purposes and ensure a plentiful supply for others.

What was the role of the central bank in Korea’s development miracle? The Minister of Finance supervised and regulated all the activities of the banking system, including those of the central bank (the Bank of Korea). As in France and China, the Republic of Korea’s central bank was subservient to these planning institutions and performed its assigned roles, which evolved over time. Although the central bank was established with some degree of independence under the guidance of two experts from the New York Federal Reserve in the 1950s, it was soon placed under the de facto control of the Ministry of Finance, until this subservience was formally enshrined in legislation in 1962 [Maxfield, 1997, p. 113]. At that time, the powers of the Bank were distributed amongst a number of entities, while the Bank of Korea itself was left only with credit policy. “This left a central bank that over the next several decades did little more than implement credit policies in line with policies designed by the Economic Planning Board and the Ministry of Finance. In fact, the bank was commonly called the ‘Namdaemun branch of the finance Ministry’ referring to the Seoul district in which the bank is located.” [Maxwell, 1997, p. 113] Over the following two decades, the central bank remained politically weak. The Bank oversaw the commercial banks’ implementation of credit distribution plans drawn up by the Economic Planning Board in accordance with overall industrialization goals. Since government controls also limited the development of the financial sector, a strong financial constituency did not develop to oppose the credit market policies [ibid, p. 115]. Complementing the control over the financial sector was an extensive set of exchange and capital controls [Nembard, pp. 85-92.]. These controls allowed the Korean government to keep interest rates low when they so chose and to allocate credit to desired purposes without much spillage overseas. They also helped to prevent macro-level financial instability arising from unstable inflows and outflows of capital or from excessive short-term borrowing.

Similar to other countries, in the 1990s, the Republic of Korea liberalized its financial system, eventually leading to the crisis of the late 1990s. Since that time, the Bank of Korea has been far more preoccupied with overall macroeconomic policy, and has had fewer tools and less of a mandate to act as an agent of development.

Brazil presents an interesting contrast with the Republic of Korea. As in Korea, Brazil’s central bank was part of a developmental apparatus directed at promoting growth and development. However, because of insufficient planning coherence, use of the financial apparatus was not as successful as in the Republic of Korea. (See Box 4).

BOX 4

Brazil

Like many European central banks, the Brazilian Central Bank started off as a private bank, the Banco do Brasil, which in the early 1900s financed coffee growers and industrialists [Maxfield, p. 123]. Then, in the 1920s, the Banco do Brasil became a quasi central bank, but continued its policies of supporting these same sectors. British creditors preferred to have a ‘real’ central bank that was not so tied to domestic borrowers, but the political power of the coffee growers and industrialists prevented the creation of a central bank to the creditors liking. A half-way institution, the Superintendency of Money and Credit (SUMOC) was created in 1945 to manage foreign exchange and credit. However, the Banco do Brasil continued to formulate exchange rate and credit *policy*. It was also the recipient of legal mandatory reserves by commercial banks, though it was exempted from having to hold them itself. Hence, it was privileged, as were previous central banks in their early years, despite being profit-oriented.

Although the political battles over the creation of a full, public central bank continued, a central bank was not formally created until the military coup of 1964. As soon as it was created, however, its independent authority was undermined and it was brought under the close authority of the central government [Maxfield, p. 136].

In this context, the Brazilian central bank has been tasked with implementing central government policy. This policy itself has varied over time. When the Government was focused on reducing inflation (1965-1967), it pursued more liberal and outward-oriented policies. When the Government wanted to encourage rapid industrialization (1950s, 1967-74, 1985-87), more inward-oriented policies were pursued and the central bank contributed in classic fashion, helping to direct finances and granting favoured treatment to local industries, while implementing strict controls on inflows and outflows of capital [Nembhard, p. 145].

Yet, the implementation of these policies was not nearly as effective as in the case of the Republic of Korea. There were many factors at play. Among the most relevant for our purposes was the highly decentralized nature of the country's financial system, which made it difficult for the central bank and related institutions to monitor and control the allocation of credit. Thus, while the central bank, under the direction of the Government, tried to act as an agent of development, the relative lack of a coherent planning process and the difficulty of dealing with a more dispersed financial system led to its being less successful in industrial policy than the Republic of Korea [Nembard, ch. 5].

5.2.3 Thailand and Mexico

The cases of Thailand and Mexico present an interesting contrast with China, India, the Republic of Korea and Brazil [Maxfield, 1994; 1997]. In these cases, relatively strong and independent private financial systems, along with a stronger need to borrow from foreign creditors, led both domestic and foreign creditors to support the creation of relatively independent central banks [Maxfield, 1994] (See Box 5).

BOX 5

Thailand and Mexico

In Thailand and Mexico, the central banks were much less closely tied to the financing industry and the Governments than in China and India or Brazil and the Republic of Korea. And while their positions changed over time depending on both domestic and political factors, overall, these central banks played a larger role in attracting credit from abroad and supporting the domestic financial sectors than they did in promoting industrialization. In the 1990s, for example, in a move reminiscent of the roles of the Federal Reserve and the Bank of England, the central bank and Government of Thailand supported efforts to make Bangkok into a regional financial centre as part of a development plan [Ghosh and Chandrasekhar, 2001]. With the crash of 1997, the result was not a happy one, however.

Arguably, then, these central banks were more oriented to finance and to international creditors than to domestic industrial development. Hence, they acted less as agents of development than the central banks in the other countries.

In short, as the cases of Mexico and Thailand show, not *all* developing countries have had strong, development-oriented central banks. Where central banks were too closely tied to finance and not closely enough tied to industry, they did not play the developmental role that many other such banks played. The Thai and Mexican cases both indicate that not all developing countries

have had developmental central banks that used the financial sector for developmental purposes. They also plausibly suggest that countries that have not had developmental central banks have paid a developmental price.

5.3 IMPLICATIONS

The mobilization, allocation and monitoring of medium- and long-term credit were crucial to the success of the newly industrialized economies in the post-war period. However, the role of central banking in supporting these policies varied from country to country, as a function of an array of complex factors, including inherited financial and industrial structures, the need for international finance, and various idiosyncratic factors that affected the politics of central banking. The wealth of case studies shows that developmental central banks are not empirically anomalous. In some countries, such as China, India and Republic of Korea, conditions were ripe for central banks to play a key role as agents of development. In others, such as Brazil, the central bank played its role, but the overall structure was highly imperfect. In others, such as Thailand and Mexico, the central bank was not as firmly a part of the planning apparatus and tended to be more oriented to the needs of the domestic and international financial interests than to those of the government or industry.

In all cases where central banks played a crucial role, their connections with the state and with credit allocation, coupled with their use of capital and exchange controls to manage the international sector, were absolutely critical to their success. This approach hardly follows the recipe of an independent central bank of the sort envisioned by orthodox economists.

6 THE EXTERNAL FINANCIAL SECTOR AND PRO-POOR GROWTH: A CONSIDERATION OF POLICY OPTIONS

There is evidence from a variety of countries that well-designed policies to manage international private capital flows have played important roles during crucial periods in the development process. We term such policies 'capital management techniques,' following Epstein et al. [2004]. Capital management techniques include (but are not limited to) measures that manage the volume, composition or allocation of capital flows and/or the maintenance of restrictions on investor entrance and exit opportunities.

Nearly all developed countries utilized capital management techniques successfully over long periods. For example, continental European countries employed extensive capital management techniques during the economic reconstruction that followed World War II. Even the U.S.A.—arguably the home of free capital flows, and also a country where the financial system has benefited substantially from the receipt of flight capital from around the world—employed temporary capital management policies in 1963 because they were warranted by economic circumstances.

Capital management techniques played critically important roles during the high-growth eras of Japan and Republic of Korea and were successfully employed in Brazil in the 1950s and 1960s (e.g., Nembhard, 1996). Chile and Colombia successfully used capital management techniques during the 1990s. The Malaysian government successfully employed stringent capital management policies in 1994 and 1998. India, Singapore, China and Taiwan POC employed diverse strategies that could be termed (even if not by the Government itself) capital management techniques during the 1990s.

We argue that this is a propitious moment for advocates of pro-poor growth strategies to consider the role that capital management techniques can play in *supporting* pro-poor growth strategies. As we will see, some types of capital management techniques have a proven track record, not just in the decades that followed World War II, but in the current environment as well. This latter fact is increasingly recognized today, even by many prominent economists and the IMF [e.g., Prasad et al., 2003] who have recently written rather positively—though nevertheless cautiously—about the role of certain types of market-based, temporary capital management techniques.

Another reason that this is a propitious moment for advocates of pro-poor growth to consider capital management techniques is that the problems associated with unfettered international private capital flows have become quite obvious, particularly in light of the financial crises in the developing world during the 1990s. And finally it must be said that a pro-poor growth agenda simply cannot succeed in the absence of some type of management of international capital movements. Capital management techniques are not an end in themselves. Rather they are a critical supporting player in a broader financial landscape in which the domestic financial system mobilizes and channels domestic savings with the support of a developmentalist central bank.

At this point, it is important to recall the three general points that we made in connection with our discussion of policies toward the domestic financial sector (see section 4 of this module). Our earlier comment on nationally-specific policies is relevant to this discussion of international capital flows insofar as policies designed to manage certain types of international private capital flows are relevant to some countries, and not to others. We know that for many developing countries, the question of how to manage excessive Portfolio Investment (PI) and FDI inflows is merely theoretical because they attract little to none of these flows in the first place. For some developing countries, private remittances are extremely important as a source of external finance, whereas for others this is not the case.

With regard to our earlier discussion of dynamic financial policies, it is worth mentioning here Grabel's [2004] proposal that developing countries implement a system of dynamic, narrowly targeted and transparent capital management techniques that policymakers activate gradually once particular types of financial vulnerabilities are identified. There are certainly circumstances under which more-or-less static capital management techniques are appropriate. However, there are other national environments in which dynamic capital management techniques can be useful and feasible. In such environments, capital management techniques are activated whenever information about the economy indicates that such policies are necessary to prevent nascent macroeconomic fragilities from culminating in serious difficulties or even in a crisis.

There are two tools envisioned in this approach—'trip wires' and 'speed bumps'. Trip wires are simple measures that warn policymakers and investors that a country is approaching high levels of risk in various domains (e.g., currency collapse, the flight of foreign lenders or investors, and the emergence of fragile financing strategies). Once a trip wire predicts the emergence of a particular vulnerability, policymakers would then immediately take steps to curtail this risk by activating a targeted, graduated capital management technique, termed a speed bump. Developing countries at different levels of wealth require distinct trip-wire thresholds. Trip wires would have to be appropriately sensitive to subtle changes in the risk environment and adjustable. Sensitive trip wires would allow policymakers to activate graduated speed bumps well before conditions for investor panic had materialized. (See sections 6.1-6.2 of this module for specific examples).

We divide our discussion of policy options toward private international capital flows into several sections—policies toward foreign bank borrowing (section 6.1), portfolio investment (section 6.2), FDI (section 6.3) and private remittances (section 6.4).¹⁶ Our discussion of these

diverse types of private international capital flows is motivated by the view that appropriate capital management techniques can increase the likelihood that different types of international capital flows support—and certainly do not disrupt—a pro-poor growth agenda. The attraction of any type of private international capital flows, without discrimination, should not be seen as a panacea by policymakers (and accordingly, we do not describe policies to attract private international capital flows). Rather, the question is how appropriate capital management techniques can maximize the developmental potential of these flows. Section 6.5 presents a brief discussion of the complementarity between efforts to manage the exchange rate and international private capital flows. A thorough treatment of strategies toward the exchange rate is, of course, outside the scope of this module.

Tables 5 and 6 summarize many of the key aspects and impacts of the capital management techniques employed by a range of developing countries during the 1990s [from Epstein, Grabel and Jomo, 2004]. These tables complement the discussion below by giving quite specific and concrete country experiences to illustrate the general points about capital management techniques in the analysis that follows.

TABLE 5

Experiences with Capital Management Techniques in the 1990s*

Country	Types of Capital Management Techniques	Objectives of Capital Management Techniques
Chile	<p>Inflows <u>Inflow management</u> FDI and PI: one year residence requirement 30 per cent URR <i>Borrowing Restrictions:</i> Tax on foreign loans: 1.2 per cent per year</p> <p>Outflows - no restrictions</p> <p>Domestic Financial Regulations - strong regulatory measures</p>	<ul style="list-style-type: none"> - lengthen maturity structures and stabilize inflows - help manage exchange rates to maintain export competitiveness - protect economy from financial instability
Colombia	Similar to Chile	Similar to Chile
Taiwan POC	<p>Inflows <u>non-residents</u> - bank accounts can only be used for domestic spending, not financial speculation - foreign participation in stock market regulated - FDI tightly regulated</p> <p><u>residents</u> - regulation of foreign borrowing</p> <p>Outflows - exchange controls</p> <p>Domestic Financial Regulations - restrictions on lending for real estate and other speculative purposes</p>	<ul style="list-style-type: none"> - promote industrialization - help manage exchange rate for export competitiveness - maintain financial stability and insulate from foreign financial crises
Singapore	<p>Inflows 'Non-Internationalization' of Singapore \$</p> <p>Outflows <u>non-residents</u> - financial institutions cannot extend S\$ credit to non-residents if they are likely to use it for speculation</p>	<ul style="list-style-type: none"> - to prevent speculation against Singapore \$ - to support 'soft peg' of S\$ - to help maintain export competitiveness - to help insulate Singapore from foreign financial crises

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	<ul style="list-style-type: none"> - if non-residents borrow for use abroad, must first swap into foreign currency <p>Domestic Financial Regulations</p> <ul style="list-style-type: none"> - restrictions on creation of swaps and other derivatives that could be used for speculation against S\$ 	
Malaysia	<p>Inflows</p> <ul style="list-style-type: none"> - restrictions on foreign borrowing <p>Outflows</p> <p><u>non-residents</u></p> <ul style="list-style-type: none"> - 12-month repatriation waiting period - graduated exit levies inversely proportional to length of stay <p><u>residents</u></p> <ul style="list-style-type: none"> - exchange controls <p>Domestic Financial Regulations</p> <p><u>non-residents</u></p> <ul style="list-style-type: none"> - restrict access to ringit <p><u>residents</u></p> <ul style="list-style-type: none"> - encourage to borrow domestically and invest 	<ul style="list-style-type: none"> - to maintain political and economic sovereignty - kill the offshore ringit market - shut down offshore share market - to help reflate the economy - to help create financial stability and insulate the economy from contagion
India	<p>Inflows</p> <p><u>non-residents</u></p> <ul style="list-style-type: none"> - strict regulation of FDI and PI <p>Outflows</p> <p><u>non-residents</u></p> <ul style="list-style-type: none"> - none <p><u>residents</u></p> <ul style="list-style-type: none"> - exchange controls <p>Domestic Financial Regulations</p> <ul style="list-style-type: none"> - strict limitations on development of domestic financial markets 	<ul style="list-style-type: none"> - support industrial policy - pursue capital account liberalization in an incremental and controlled fashion - insulate domestic economy from financial contagion - preserve domestic savings and forex reserves - help stabilize exchange rate
China	<p>Inflows</p> <p><u>non-residents</u></p> <ul style="list-style-type: none"> - strict regulation on sectoral FDI investment - regulation of equity investments: segmented stock market <p>Outflows</p> <p><u>non-residents</u></p> <ul style="list-style-type: none"> - no restrictions on repatriation of funds - strict limitations on borrowing Chinese Renminbi for speculative purposes <p><u>residents</u></p> <ul style="list-style-type: none"> - exchange controls <p>Domestic Financial Regulations</p> <ul style="list-style-type: none"> - strict limitations on residents and non-residents 	<ul style="list-style-type: none"> - support industrial policy - pursue capital account liberalization in incremental and controlled fashion - insulate domestic economy from financial contagion - increase political sovereignty - preserve domestic savings and foreign exchange reserves - help keep exchange rates at competitive levels

Source: Epstein, Gabel and Jomo, 2004.

*This description applies to the experience during the 1990s and not necessarily during the current period.

TABLE 6

Effects of Capital Management Techniques in Seven Cases

Country	Achievements	Supporting Factors	Costs
Chile	<ul style="list-style-type: none"> - altered composition and maturity of inflows - reduced vulnerability to contagion 	<ul style="list-style-type: none"> - well designed policies - offered foreign investors good returns - state capacity - flexible application 	<ul style="list-style-type: none"> - higher cost of capital for small firms
Colombia	<ul style="list-style-type: none"> - similar to Chile but less successful 	<ul style="list-style-type: none"> - less state capacity than Chile - less flexible 	
Taiwan POC	<ul style="list-style-type: none"> - kept debt load manageable - helped keep competitive exchange rate - insulated from financial crises - helped maintain economic sovereignty 		
Singapore	<ul style="list-style-type: none"> - insulated from disruptive speculation - helped manage soft peg - contributed to financial strength 	<ul style="list-style-type: none"> - strong state capacity - strong economic fundamentals 	<ul style="list-style-type: none"> - possibly contributed to a less developed financial sector
Malaysia	<ul style="list-style-type: none"> - facilitated macroeconomic reflation - helped to maintain domestic economic sovereignty 	<ul style="list-style-type: none"> - public support for policies 	<ul style="list-style-type: none"> - possible cronyism/ corruption
India	<ul style="list-style-type: none"> - facilitated incremental liberalization - insulated from financial contagion - helped preserve domestic saving - helped maintain economic sovereignty 	<ul style="list-style-type: none"> - strong state and bureaucratic capacity - strong public support 	<ul style="list-style-type: none"> - restricted the development of the domestic financial sector
China	<ul style="list-style-type: none"> - facilitated industrial policy - insulated economy from financial contagion - helped preserve savings - helped manage exchange rate and facilitate export led growth - helped maintain expansionary macro-policy - helped maintain economic sovereignty 	<ul style="list-style-type: none"> - strong state and bureaucratic capacity - strong economic fundamentals 	<ul style="list-style-type: none"> - constrained the development of the financial sector - facilitated corruption

Source: Epstein, Grabel and Jomo, 2004.

6.1 POLICIES TOWARD FOREIGN BORROWING

It is critical that developing countries drastically reduce their reliance on foreign bank loans since repayment pressures have strangled economic growth and seriously harmed the poor in many countries. It would therefore be of significant benefit if policymakers enforced strict ceilings on the volume of new foreign loans that can be incurred. Such ceilings might involve strict limits on the allowable ratio of foreign to total loans, or might require that firms finance only a specified percentage of their projects with foreign loans that have a certain maturity and/or locational profile.

Restrictions on foreign lending could be deployed dynamically as circumstances warrant, following the trip wire-speed bump approach. Under this approach, policymakers would monitor a trip wire that measured the economy's vulnerability to the cessation of foreign lending. This involves calculating the ratio of the government's holdings of currency reserves to private and public foreign-currency denominated debt (with short-term obligations receiving a greater weight in the

calculation). If this ratio approached an announced threshold, policymakers would then activate a graduated speed bump that precluded new inflows of foreign loans until circumstances improved.

Policy can also discourage—rather than prohibit—the use of foreign loans as a source of finance. The tax system can be used in a number of ways to discourage domestic borrowers from incurring foreign debt obligations. Domestic borrowers might pay a fee to the Government or the central bank equal to a certain percentage of any foreign loan undertaken. This surcharge might vary based on the structure of the loan, such that loans involving a locational or maturity mismatch would incur a higher surcharge.¹⁷ Alternatively, the surcharge might vary based on the level of indebtedness of the particular borrower involved, such that borrowers who already held large foreign debt obligations would face higher surcharges than did less-indebted borrowers.

This tax-based approach could encourage borrowers to use domestic sources of finance since these would not carry any surcharge. Another strategy might involve varying the surcharge according to the type of activity that was being financed by foreign loans. For instance, borrowers might be eligible for a partial rebate on foreign loan surcharges when loans were used to finance types of production that were highly employment intensive.

Note that policymakers in Chile and Colombia employed tax-based policies to discourage foreign borrowing during much of the 1990s. In Chile, foreign loans faced a tax of 1.2 per cent per year (payable by the borrower). Chilean policymakers also imposed a non-interest bearing reserve requirement of 30 per cent on all types of foreign debts (and indeed, on all foreign financial investments in the country). This policy, termed the reserve requirement tax, was in place from May 1992 to October 1998. The required reserves held against foreign obligations (and payable by the borrower) were kept at the Central Bank for one year, regardless of the maturity of the obligation.

Authorities in Colombia also employed a reserve requirement tax specifically designed to discourage domestic borrowers from incurring foreign loans. Beginning in September 1993, Colombian policymakers required that non-interest bearing reserves of 47 per cent be held for one year against foreign loans with maturities of 18 months or less (this was extended to loans with a maturity of up to five years in August 1994).¹⁸ In addition, foreign borrowing related to real estate transactions was prohibited. Empirical studies of Chilean and Colombian policies conclude that they achieved their principal objectives, including the reduction in foreign borrowing [see Grabel, 2003a, and references therein].

To the extent that borrowers assume at least some foreign loan obligations, it is imperative that the allocation and terms of these loans be managed by the Government. Careful management of the allocation of foreign debt can ensure that it is used for productive, developmental purposes. Prior to financial liberalization in the 1990s, many governments in East and Southeast Asia tightly coordinated allocation and access to foreign loans.

Until quite recently, policymakers in China and India maintained tight restrictions on foreign borrowing through a variety of means [for details, see Epstein et al., 2004]. For example, Chinese domestic firms were required to obtain government approval for any foreign loans undertaken. The Indian Government maintained firm restrictions over the level and terms of the external debts held by domestic firms. Responding to the lessons of the 1997 Asian crisis, India restricted commercial borrowing in foreign currencies. The Ministry of Finance still maintains annual ceilings on the size and interest rate on loans sought by domestic firms. The Ministry also rules on requests for foreign loans on a case-by-case basis, basing its determinations on the maturity structure and end-use of the proposed loans. In the approval process, priority is given to longer-term loans and

loans for priority sectors. Firms in China and India have low levels of external indebtedness and external financial fragility precisely because of government policies towards external debt.

In general, policymakers should implement measures that restrict or otherwise discourage domestic borrowers from using financing strategies that involve locational and maturity mismatch. In addition to the ceilings, surcharges or approval processes discussed above, policymakers can design trip wires and speed bumps that keep the levels of maturity and/or locational mismatch below the critical thresholds. A trip wire for locational mismatch is the ratio of foreign-currency denominated debt to domestic-currency denominated debt (with short-term obligations receiving a greater weight in the calculation). A trip wire for maturity mismatch is the ratio of short-term debt to long-term debt (with foreign-currency-denominated obligations receiving a greater weight in the calculation). A graduated series of speed bumps that require borrowers to reduce their extent of locational or maturity mismatch would be implemented whenever trip wires revealed the early emergence of these vulnerabilities.

In those cases where foreign loans have been significant, economic reforms that promote growth can replace the resources initially lost if there is a reduction in foreign borrowing due to the measures described above. Governments and central banks that take steps to restrict foreign borrowing can replace at least some of the finance that is foregone by implementing measures that increase their ability to mobilize and channel domestic saving to projects that are central to a pro-poor growth agenda. In this connection, measures that restrict the exit options of domestic savers and businesses would increase the pool of capital available domestically (since much of it is presently lost to capital flight, see section 6.2 of this module).

The coordination of industrial policy and domestic financial regulation can also ensure that domestic firms have access to capital that is generated domestically. Tax reform is yet another means of increasing the domestic resource base. More generally, a multi-faceted pro-poor growth agenda will generate higher levels of investment and economic growth over time. If this approach is successful, the economy in the medium- to long-term will generate new domestic resources that can be used to finance additional investment.

6.2 POLICIES TOWARD PORTFOLIO INVESTMENT

Management of portfolio investment (PI) warrants serious consideration. Various types of management techniques have contributed importantly to economic development in a range of countries. Careful management of PI can maximize the benefits and minimize the costs associated with this resource. Many countries have successfully regulated PI for extended periods of time. For instance, during the two decades that followed World War II, all industrialized countries heavily regulated PI inflows and outflows [Helleiner, 1994]. The only exception was the USA, but even it resorted to temporary management of PI for a short time in the 1960s when policymakers sought to enhance confidence in the country's faltering economy. Indeed, most Continental European countries and Japan maintained stringent management of portfolio and other capital flows until the mid-1980s.

The use of capital management techniques was not confined to wealthy countries. Management of PI was the norm in developing countries until orthodoxy in economic policy attained prominence. By any reasonable account, management of portfolio and other capital flows contributed importantly to the success of numerous developing countries during the era of their strongest economic performance, namely, the period between the 1950s and the mid-1970s. Compared to the orthodox era, developing countries as a whole witnessed impressive economic performance during the three decades that followed World War II, a time when capital

management techniques were used widely. Management of capital movements (in addition to industrial and trade policy) contributed significantly to the strong economic performance of many East and Southeast Asian countries during the 1970s and 1980s.

Some developing countries continue to use (or have recently used) techniques to manage PI in the service of important objectives. And even in the current climate, a few large developing countries—some until quite recently—have effectively utilized techniques to manage PI inflows and outflows. Here, we identify recent examples of such strategies.

Malaysian authorities twice imposed restrictions over PI during the 1990s. The first such effort was in early 1994. At that time, the Malaysian economy received dramatic increases in the volume of private capital inflows (including, but not limited to, PI). Policymakers were concerned that these inflows were feeding an unsustainable speculative boom in real estate and stock prices and were creating pressures on the domestic currency. In this context, policymakers implemented stringent, temporary inflow-capital management policies. These measures included restrictions on the maintenance of domestic currency-denominated deposits and borrowing by foreign banks, management of the foreign exchange exposure of domestic banks and large firms, and prohibitions on the sale to foreigners of domestic money market securities with a maturity of less than one year.

Reaction to these measures was rapid and dramatic, so much so that authorities were able to dismantle them as planned in under a year (since they achieved their goals during this time). During the period that the capital management techniques were in place, the volume of net private capital inflows and short-term inflows fell sharply, the composition of these flows was altered significantly, pressure on the currency was reduced, and the inflation of stock and real estate prices was curtailed [Palma, 2000]. The immediate, powerful reaction to these temporary capital management policies underscores the potential of speed bumps to stem such incipient difficulties successfully.

The Malaysian government again implemented stringent management of capital inflows and outflows in 1998 during the East Asian financial crisis. This effort involved restrictions on foreign access to the domestic currency, on international transfer and trading of the currency, and on the convertibility of currency held outside of the country. The Government also established a fixed value for the domestic currency, closed the secondary market in equities, and prohibited non-residents from selling local equities held for less than one year.

By numerous accounts, these stringent measures prevented the further financial implosion of the country—a notable achievement since the country was also gripped by a severe political and social crisis during this time. Comparing the situation of Malaysia to other countries that were affected by the Asian crisis, studies find that the country's capital management techniques were responsible for the faster recovery of its economy and stock market as well as the smaller reductions in employment and wages [Kaplan and Rodrik, 2001]. The latter achievements were possible because capital management techniques provided the Government with the ability to implement reflationary economic and social policies uninhibited by the threat of additional capital flight or IMF disapproval.

From 1992 to 1998, policymakers in Chile and Colombia regulated PI extensively and successfully. During that time, the Colombian Government did not allow foreign investors to purchase debt instruments or corporate equity. This policy was designed to prevent the possibility that financial instability could be induced by the sudden exit of foreign investors from liquid investment holdings. However, there were no significant capital management techniques that

focused on FDI. The differential treatment of FDI and PI was intended to promote the type of foreign investment that the Government deemed important to economic growth, while protecting the economy from destabilizing forms of investment.

The Chilean Government had similar motivations for its policy toward foreign investment in the country. By using the reserve requirement tax of 30 per cent on foreign investment, the government sought to lengthen the time horizon of investment and encourage more stable forms of foreign investment. FDI and PI faced a one-year residence requirement. The Government also prevented pension fund managers from investing more than 12 per cent of their assets abroad. This policy was intended to curb the possibility of capital flight by the most important type of large domestic investor.

Numerous empirical studies conclude that capital management techniques in Chile and Colombia played a constructive role in changing the composition and maturity structure (though not the volume) of net capital inflows, particularly after capital management techniques were strengthened in 1994-95 [see Grabel, 2003c, and references therein]. Following implementation of these policies in both countries, external financing in general moved from debt to FDI. Policymakers in both Chile and Colombia were able to implement growth-oriented policies because the risk of foreign investor flight was significantly curtailed by their capital management techniques.

Finally, the macroeconomic stability fostered by these management techniques contributed to the financial stability experienced by Chile and Colombia following the Mexican and the Asian financial crises. For instance, while other countries in Latin America were devastated by these events (due to the exit of investors from equity and government bond markets), Chile remained largely stable and only began to experience a significant reduction in private capital inflows in August 1998.

In the case of China, up until the gradual move to liberalize international financial flows that began a few years ago, the participation of foreigners in equity markets was limited very strictly, and the activities of its largely state-owned banks were circumscribed (e.g., lending to foreigners for certain kinds of projects was tightly regulated and access to foreign currency severely restricted). Chinese residents also faced obstacles to capital expatriation. In fact, the Chinese Government tightened restrictions and introduced new techniques to manage finance following the Asian crisis.

As the crisis unfolded, the Chinese Government announced new restrictions on foreign exchange transactions involving more than US\$ 100,000, introduced new measures making it more difficult for domestic and international companies to move money into and out of the country, and introduced strict new penalties on Chinese companies that maintained illegal foreign currency deposits overseas. Similarly, during the Asian financial crisis, authorities in Taiwan POC also took steps to prevent illegal trading of funds managed by George Soros (because these funds were blamed for causing the local stock market to fall).

There is a strong case for restricting the access of domestic savers to foreign capital markets. The flight of domestic investors can induce financial instability, as well as reduce the tax base and the pool of domestic savings available for allocation by domestic financial institutions. For these reasons, there is a strong case for restricting the ability of domestic investors to hold foreign savings accounts and engage in capital flight.

In the mid-1980s, despite being the fourth largest foreign debtor in the world, the Republic of Korea was saved from a debt crisis partly because of stringent management of capital outflows. China and India provide more recent examples. China maintained firm restrictions on the ability

of domestic investors to engage in foreign PI until a few years ago (by limiting their access to foreign currencies in the first place). India, too, has been gradually loosening its traditionally firm management of international financial flows over the last few years. Prior to liberalization, the exit options of domestic investors were tightly restricted via limitations on their access to foreign currency. Indian residents and firms were simply precluded from maintaining foreign currency accounts abroad, while Indian banks could not accept deposits or extend loans in foreign currencies. Recent studies have shown that the combined effects of restrictions on capital flight, currency speculation and access to foreign currency and loans protected China and India from instability during the Asian financial crisis.

The above discussion suggests that there are several directions for managing portfolio investment (PI). The success of blunt restrictions on PI in China, India, Chile and Colombia suggest that foreign investors do not necessarily shun countries with minimum-stay requirements on foreign investment or other types of capital management techniques. We have also seen that the tax system can be used to influence the composition and/or maturity structure of international capital flows. The potential for flight by domestic investors and savers can be reduced via implementation of exit taxes, prohibitions on flight or restrictions on access to foreign currencies. Finally, the Malaysian experience suggests that speed-bump style management of PI can be effective as well.

The trip wire-speed bump approach lends itself to the design of temporary management of PI. A trip wire that would reveal the vulnerability to the risk of PI flight is the ratio of total accumulated foreign PI to gross equity market capitalization or gross domestic capital formation. If the trip wire revealed that a country were particularly vulnerable to the reversal of PI inflows, a graduated series of speed bumps would slow the entrance of new inflows until the ratio fell either because domestic capital formation or gross equity market capitalization increased sufficiently or because foreign PI fell. Thus, a speed bump on PI would slow unsustainable financing patterns until a larger proportion of any increase in investment could be financed domestically. We emphasize the importance of speed bumps governing *inflows* of PI because they exert their effects at times when the economy is attractive to foreign investors; thus, they are not as likely to trigger investor panic as are outflow restrictions. Although not a substitute for outflow management, inflow restrictions also reduce the frequency, as well as the magnitude, with which the former must be used.

6.3 POLICIES TOWARD FDI

Because Foreign Direct Investment (FDI) is a type of financial flow, it is highly relevant to a module on financial policy. At the same time, FDI can also be more than a financial flow: it can arrive along with a package of technology, access to international markets, and expertise in sales and production. FDI can come in two general forms: as a so-called 'Greenfield' investment, where new plant and equipment are associated with FDI; or it can arrive as part of a merger and acquisition (M&A), where a foreign investor buys more than 10 per cent of the equity of a domestic firm (a so-called 'Brownfield' investment).

FDI is seen as a highly desirable form of international investment by many developing countries because governments often see it as: 1) more stable than other flows, 2) as a mechanism for bringing a great deal of net capital into the country, 3) as a vehicle for bringing new technology and expertise and 4) as a means for promoting integration with international markets.

In view of these perceived benefits, many developing countries are willing to make significant (and often costly) adjustments to domestic economic policy and institutions in order to attract FDI

inflows. A key question is whether the benefits of FDI inflows offset the costs associated with the policy and institutional changes that are often undertaken to attract them.

An extensive literature has assessed the impacts of FDI on developing countries. Most of it finds that the positive impacts are, in general, smaller than many developing country governments believe (Hanson, 2001; UNCTAD, 2000). In most cases, there are modest degrees of technology and skill transfer; limited degrees of employment generation; limited net inflows of capital due to domestic sourcing of funds and profit remittances; and limited linkages to the domestic economy (this is reflected in modest increases in value added in production). Some evidence also suggests that FDI flows are not significantly more stable than portfolio flows. Finally, as discussed in section 2.3, most countries, no matter how hard they try, can attract only very limited amounts of FDI, especially since most of it flows to a relatively small number of developing countries.

Still, under the right circumstances and with the appropriate institutional structures, FDI inflows can contribute to development. An examination of historical experiences suggests the ways in which FDI as a financial inflow can be managed in a development friendly manner. (See Box 6).

BOX 6

A Developmental Approach to FDI

Some countries, especially in East Asia, offer particularly good recent examples of strategies for maximizing the developmental benefits of FDI. Even more recently, China, India and Vietnam have adopted highly strategic attitudes toward FDI (rather than the 'open door' policy in place in so many countries). The experience of this latter group of countries demonstrates that foreign investors will not necessarily shun countries that apply capital management techniques to FDI. Indeed, evidence also shows that when deciding where to channel their resources, foreign investors place more emphasis on a large domestic market, an educated workforce, rising incomes, economic growth and sound infrastructure than on a liberal regulatory regime. Thus, policymakers in developing countries have no reason to think that low wages and lax regulation are appropriate strategies for attracting FDI.

FDI policy stands the best chance of contributing to pro-poor growth objectives if policymakers develop a clear vision as to how it contributes to the country's overall macroeconomic aims. Countries such as Republic of Korea and Taiwan POC are known to have used strict regulation on FDI in most industries, while also taking a very liberal attitude towards FDI in others. This mixture of restrictive and liberal policies was possible because the Governments developed a clear FDI strategy that differentiated industries. The recent experiences of Singapore and Costa Rica show that policymakers can target the attraction of particular types of FDI (or even target particular firms) as a central part of their overall economic strategy. For example, the potential of different types of FDI might be gauged according to their employment multiplier.

The precise strategy toward FDI taken in any particular country should depend on the nature of the FDI that is being sought, the country's endowments, and the growth and poverty-reduction objectives of the Government. Some countries, especially the poorest ones, may have narrow goals for FDI, seeking only an infusion of foreign capital that will increase employment (under any terms), reduce poverty and attract foreign exchange. The industries for garments, shoes and toys often function in this limited, but in some cases, economically important capacity.

In such cases, it may be acceptable—or even important—that the country remain open to FDI because the industries are seen strictly as a strategic means to attract foreign capital in the short run. Many countries have established export processing zones for the purpose of attracting FDI to these types of industries. However, it should be noted that the types of industries that tend

to populate export-processing zones are often developmental dead ends in the long run. Therefore, policymakers need to devise a strategy to reinvest the export earnings generated by such industries in order to generate new industrial capabilities.

In some countries and in some industries, the Government may find it necessary to induce foreign investors to undertake expensive investments in capital equipment and technology. These types of foreign investments can sometimes be a precondition for using the country's natural resources to some advantage because the technology or finance necessary to exploit or extract natural (e.g., mineral) resources is not always available domestically. In this context, it may be necessary to adopt an FDI strategy for a sector that is attractive to foreign investors, but allows the host country to extract the largest possible 'rent' from their own natural resources. Carefully structured joint-operating agreements have worked well in some countries.

In some cases, the Government may seek to promote certain industries as part of an industrial policy aimed at creating long-run international competitiveness in some realm. At the early stages, this might necessitate a major injection of new technology and capital, a circumstance that necessitates the participation of foreign firms. In this type of situation, it is important for the national government to negotiate with foreign firms over technology transfer and prevent these firms from imposing restrictions on exports and R&D. These matters were well negotiated in the cases of the Chinese auto industry and the Korean fast train project in the mid-1990s.

Finally, in those cases in which the country is reasonably close to achieving international competitiveness in a particular industry, it may be necessary to exclude foreign firms altogether. This is especially important where the domestic market is small. This restriction may be necessary so that local firms have the greatest possible opportunity to develop their competitive advantage.

The main point is that there is no single appropriate strategy for all types of FDI and for all types of countries. Policies towards FDI must be tailored to the particular conditions of each industry and each country. And, as with other types of capital flows, management of FDI must be dynamic so that policy evolves as internal and external conditions change.

6.4 POLICIES TOWARD PRIVATE REMITTANCES

Researchers have only recently begun to examine the contribution of remittances to economic growth, investment, household consumption and poverty reduction. Indeed, Solimano [2003] is one of the only studies that address these macroeconomic issues in a preliminary fashion. Rempell [2005] considers these issues in the Mexican context. At this point, there is a great deal more empirical work to be done, particularly with regard to how recipients use these funds (i.e., whether they smooth consumption or promote investment) and whether they substitute for or complement savings by recipients.

There is reason to consider mechanisms that reduce the cost of sending and receiving remittances in order to increase the size of the potential remittance pool. It is also important to increase the ability of the domestic banking system in recipient countries to mobilize these funds in accordance with a pro-poor growth agenda. Some of the initiatives discussed in section 4.2 may be useful in the latter connection.

Solimano [2003] argues that on the sending-country side, banks should be encouraged to develop new low-cost product lines for migrants, such as special checking, savings or ATM accounts. On the recipient country side, he suggests several strategies. For example, governments and local financial institutions can issue interest-bearing bonds for emigrants as a vehicle for channelling remittances; housing and education accounts can be created to channel

remittances to these activities in the home country; and alliances can be created between domestic banks in the receiving countries and banks in the sending countries with the goal of reducing the costs of remittances.

Rempell's [2005] work on remittances to Mexico has relevance beyond the country. He proposes the creation of opportunities for migrant workers to remit their earnings into foreign currency accounts in domestic banks. He acknowledges that this measure alone might not reduce the cost of remittances in rural areas since large banks rarely have a presence outside of the cities. For that reason, he suggests that microfinance institutions should become eligible to receive international transfers. He also describes an innovative program in the Mexican state of Zacateca that is designed to leverage the developmental potential of remittances. Beginning in 1992, the local government began to match (initially at a two-for-one, and now at a three-for-one, rate) monies that were sent to the state by 'home town associations' of migrants living in the U.S.A..

6.5 A BRIEF DISCUSSION OF THE COMPLEMENTARITY BETWEEN THE MANAGEMENT OF EXCHANGE RATES AND INTERNATIONAL CAPITAL FLOWS

As noted in the introduction to this section, a discussion of strategies toward the exchange rate is outside the scope of this module.¹⁹ There may be good reasons (indeed, very good reasons) for countries to pursue diverse types of managed exchange rate regimes, such as crawling or adjustable currency pegs. These approaches have played important roles in promoting industrialization, export and employment growth and financial stability in many countries in the post-WWII period and in the recent era [see discussion in Chang and Grabel, 2004, ch. 11; Williamson, 2002].

For the purposes of this module, we simply note that managed exchange rate regimes of any type are sustainable only if supported by techniques to manage international capital flows. This is because high volumes of international capital inflows or outflows make it difficult for authorities to maintain any type of currency peg within a pre-determined range. Absent the ability to maintain the exchange rate within a pre-determined range, the best laid plans to promote export, employment and/or pro-poor growth and macroeconomic stability will be compromised. Moreover, authorities will need to maintain extremely large holdings of foreign exchange reserves in order to protect the currency from a speculative attack—a circumstance that carries with it large opportunity costs.

7 CONCLUSIONS

We have argued that the financial landscape in developing countries faces serious challenges involving excessively high real interest rates, low levels of credit creation, and a dearth of long-term, 'patient' capital and capital for small- and medium-sized enterprises and poor households. The global financial landscape is also inadequate to the task of promoting pro-poor growth in the developing world. Globally, financial markets are characterized by a misallocation of savings and by the pro-cyclical nature of credit and capital flows.

We have also argued that the policies of financial liberalization that have been pursued in many developing countries over the last quarter century have exacerbated the challenges facing them. In particular, financial liberalization has often led to greater inequality and to a stagnation of incomes and employment opportunities for the poor.

The main contribution of this Training Module on Financial Policy has *not* been to demonstrate the inadequacy of the developing-country or the global financial landscape. Rather, the chief contribution of this work has been to demonstrate that there exists a wide range of strategies that financial policymakers in developing countries can use to promote pro-poor growth. Of course, financial policies alone are not a panacea for the poverty that plagues the developing world. Moreover, the challenges associated with significant financial reform cannot be ignored. However, it is imperative that we recognize that properly formulated and nationally specific financial policies can play an important role in providing finance for employment and in building assets by the poor, can help stabilize the macro-economy, and can enhance the economic and social power of the poor in the developing world.

We have argued that the financial sector has numerous important roles to play in promoting pro-poor growth. It can:

- Mobilize savings that can be used for productive investment and employment generation;
- Create credit for employment generation and poverty reduction at modest and stable real interest rates;
- Allocate credit for employment generation and help the poor to build assets, including in agriculture, small- and medium-sized enterprises and housing;
- Provide patient (long-term) credit for productivity-enhancing innovation and investment;
- Provide financing for public investment to promote employment generation and productivity enhancement;
- Help allocate risks to those who can most easily and efficiently bear them;
- Help stabilize the economy by reducing vulnerability to financial crises and pro-cyclical movements in finance, and by helping maintain moderate rates of inflation;
- Help the poor by providing basic financial and banking services.

We have shown that there exist diverse types of financial policies and institutions that can play a useful role in promoting pro-poor growth in developing countries. In this module, we have described a large number of principles, policies and institutions—from earlier historical eras and from the current period that can and have promoted pro-poor growth. We have also described a number of more innovative policies that we believe warrant consideration by today's policymakers.

We have found that pro-poor financial policies have tended to be the most successful when they satisfied several conditions:

- They have had strong monitoring mechanisms in place to increase the likelihood that they could achieve their goals.
- They have operated in a context of robust aggregate demand so that there has been a facilitating environment for economic growth.
- They have also operated in a domestic and international environment in which there has not been a large degree of instability.
- They have been part of a coherent overall developmental plan implemented by the government.

The main policy lessons of this Training Module are that: 1) countries should not become excessively reliant on private foreign capital to fund their development since such capital can be unstable and unreliable; 2) market allocation of finance needs to be embedded in strong financial regulations often supplemented by an important role for government guidance of finance to important sectors; 3) there is a large variety of successful ways to use the financial system to mobilize and direct finance that make a judicious use of market incentives, government guarantees and monitoring to ensure that the finance goes to socially productive purposes 4) central banks, along with other public financial institutions, need to be involved in promoting a developmental role for finance; and 5) capital management techniques, usually of a dynamic and flexible nature, can be a very important tool for reducing the negative aspects of global financial integration while enhancing the positive aspects.

The overriding message of this module is that there exists a wide range of financial policies and experiences that policymakers can draw upon and adapt in accordance with their national pro-poor growth objectives.

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NOTES

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2. The discussion in sections 2.1-2.3 draws heavily on Chang and Grabel [2004, chs. 9-10]. Section 2.1 also draws on Grabel [1995] and section 2.2 of Grabel [2003a].
3. All data in this and the next paragraph from World Bank [2005].
4. This section draws on McKinley [2006a].
5. The discussion in sections 4.2.-4.4 and 4.6 draws heavily on Chang and Grabel [2004: ch. 10], except where noted.
6. Discussion of India, Pakistan and Nepal from Pickbourn [2006: 10].
7. Note that we discuss microfinance institutions, MFIs, briefly in section 4.10.
8. Public investment as a share of gross domestic investment in the post-war period ranged from a high of 58 per cent in Mexico to a low of 25 per cent in Brazil (ibid., p. 127).
9. Proposal and text from Epstein and Heintz [2006].
10. We are grateful to Lynda Pickbourn for critical research support on mechanisms to forge linkages between formal and informal financial institutions and on Gallardo's [2001] work on microfinance institutions.
11. Proposal and text from Epstein and Heintz [2006].
12. The description in this and the next paragraph is drawn from Pickbourn [2006].
13. A key determinant of the impact of inflation on economic growth and distribution, and on the cost of reducing inflation is the *causes* of inflation in any particular episode. If inflation is due to increases in aggregate demand, then the impact on economic growth and the well-being of the poor is likely to be less harmful (and even can be positive) than if the cause of inflation increases is 'supply-shocks'. Hence, an analysis of the 'optimal' level of inflation and the proper monetary policy response must include, among other factors, an identification of the causes of inflation. (Pollin and Zhu, 2006).
14. Saez [2004] is an important source for the material in this section.
15. This section draws heavily on Nembhard, 1996, and Maxfield, 1994, 1997.
16. Note that sections 6.1-6.3 and 6.5 draw heavily on Chang and Grabel [2004: ch. 9, 11] except where noted.
17. Maturity mismatch occurs when borrowers finance long-term obligations with short-term credit, leaving them vulnerable to changes in the supply and cost of credit. Locational mismatch occurs when borrowers contract debts that are repayable in foreign currency, leaving them vulnerable to currency depreciation that increases the cost of debt service.
18. Note that the level, scope and method of paying the reserve requirement tax was, in fact, changed many times during the lifespan of the policy regime in both Chile and Colombia. See Grabel [2003a] for details and Epstein, Grabel and Jomo [2004].
19. See Chang and Grabel [2004: ch. 11] for discussion of exchange rate policy.

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International Poverty Centre

SBS – Ed. BNDES, 10º andar
70076 900 Brasilia DF
Brazil

povertycentre@undp-povertycentre.org
www.undp-povertycentre.org
Telephone +55 61 2105 5000
Fax +55 61 2105 5001