THEMATIC SUMMARY REPORT: FINANCIAL LIBERALISATION

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1. Introduction

This paper is concerned with examining the effects of the macroeconomic environment and financial policies associated with alternative financial sector regimes on poverty reduction in developing countries. In particular, it seeks to assess the consequences for the macroeconomics of poverty reduction of the transition from a less to a more liberalized financial regime.

The paper draws on a set of seven country-case studies (Bangladesh, Cambodia, China, Indonesia, Mongolia, Nepal and Vietnam) prepared as part of the UNDP’s Asia-Pacific Programme on the Macroeconomics of Poverty Reduction. It attempts to identify the key mechanisms that work to render macroeconomic policies pro-poor, and examines in detail the specific ways in which alternative financial regimes affect these mechanisms and thereby advance, obstruct or neutralise the poverty reduction agenda.

Financial liberalization can affect the poverty reduction effort in two ways: directly, by facilitating or adversely affecting productive activities, which through their employment generating, income augmenting and redistributive effects impact on the level of poverty; and, indirectly, through its effect on the fiscal and monetary policies of the government and the central bank, which in turn impact on the growth of employment and output and on social sector and poverty reduction expenditures.

The direct effects of financial policies on output growth, employment and poverty can be mediated in a variety of ways. They could influence the level and pattern of investment. They can also influence the translation of potential into actual investment by affecting the access to and cost of credit for all or some economic agents. The immediate result of differential access, resulting from stringent collateral requirements for example, would be to limit investments by those who have inadequate own capital to undertake even relatively small-scale investments. Further, if the economy is characterised by segmented markets with differences in the price and profit margins that the markets would bear, we could expect such segmentation to be accompanied by a hierarchy of rates of return. Inasmuch as big capital with access to areas offering higher returns may not be willing to enter areas offering low or lower returns and medium and small capital cannot make investments because of inadequate access to credit, certain markets may be inadequately serviced by private investors. Finally, the cost of credit could affect growth not just by rationing out investments involving low private (and, possibly, high social) rates of return, but also by influencing the choice of products and technologies in a manner that effects the elasticity of employment with respect to output.

Further, certain financial policies may lead to poor monitoring and therefore to greater financial fragility of individual financial intermediaries or of the system as a whole. This could constrict the flow of liquidity and affect access to credit. Financial crises also have similar effects and necessitate adjustment policies that are contractionary in nature that impact adversely on poverty indicators. On the other hand, the transition to more market-oriented systems may be accompanied by policies that require financial institutions to
quickly deal with non-performing assets and achieve target capital adequacy ratios. This too can adversely affect the ability or willingness of banks to lend.

Financial policies can also adversely affect the poverty reduction effort because of the dilution of state regulation aimed at increasing credit access and directing credit at lower, differential interest rates to sectors like agriculture, the urban small-scale sector and rural non-agricultural activities that are important from the point of view of poverty reduction. They could also result in the withdrawal of state agencies or state-owned units from certain segments of the market leading to similar consequences.

Finally, inasmuch as financial liberalization leads to financial growth and deepening and increases the presence and role of financial agents in the economy, it forces the state to adopt a deflationary stance to appease financial interests. Those interests are against deficit-financed spending by the state for a number of reasons. To start with, deficit financing is seen to increase the liquidity overhang in the system, and therefore as being potentially inflationary. Inflation is anathema to finance since it erodes the real value of financial assets. Second, since government spending is “autonomous” in character, the use of debt to finance such autonomous spending is seen as introducing into financial markets an arbitrary player not driven by the profit motive, whose activities can render interest rate differentials that determine financial profits more unpredictable. Finally, if deficit spending leads to a substantial build-up of the state’s debt and interest burden, it may intervene in financial markets to lower interest rates with implications for financial returns. Financial interests wanting to guard against that possibility tend to oppose deficit spending.

2. The proximate determinants of poverty

Unravelling these direct and indirect effects of financial policies on poverty reduction requires identifying the proximate determinants of poverty. The effect of financial policies on these proximate determinants determines in turn the effects of those policies on poverty and the poverty reduction effort.

The seven country case studies referred to above provide the material with which we can both identify the proximate determinants and the ways in which they are influenced by the nature of financial policies adopted and by any process of transition from a regulated to a liberalised financial regime. The seven countries fall into two groups: mixed, but predominantly market-driven, economies that have seen a process of transition from a regulated to a liberalised financial regime; and economies in transition that have been dismantling their predominantly centrally controlled and planned production systems, replacing them with new institutional structures and allowing profits and market signals to determine microeconomic decision making. Needless to say, while there may be similarities in the processes of liberalisation in these two sets of countries, the nature and pace of the transition and the impact it would have are bound to vary.

Further, within each group of countries, there is one relatively large and relatively more developed country (China, in the case of the countries in transition, and Indonesia, in the
case of the mixed economies) and a number of much smaller and less developed economies. Between these subgroups too there are bound to be differences with regard to the proximate determinants of poverty as well as the nature of the transition to a more liberalised financial regime. In what follows we attempt to identify some of the principal determinants of poverty trends and the mechanisms working to influence them in all types of countries covered by the case studies.

2.1 Economies in Transition: China, Mongolia, Cambodia and Vietnam

Four of the seven countries covered in the first phase of the UNDP’s Asia-Pacific Programme on the Macroeconomics of Poverty Reduction were economies in transition. As Weeks et. al. put it, the transition involves the movement from centrally planning to market regulation through a two phase process: the dismantling of the central planning regime; and the establishment of a system involving regulated markets. In the cases being considered, the first has been completed either through the initiatives of the state or civil society or because of the disruptions caused by internal conflict, as in the case of Cambodia. But in all four of the countries, the second phase is yet to near completion and has taken widely varying institutional forms.

A priori, in the first phase there are a number of causes of potential dynamism. To start with, the removal of some restrictions characteristic of central planning, releases the pent-up demand and unrealised investment intentions reflected in the accumulation of savings or hoards under the earlier system. This, however, is a once-for-all effect that triggers a temporary boom. If the boom is to be sustained new external or domestic demand must drive the system. Second, the transition process is most often accompanied by significant inflows of foreign aid and capital that imparts a degree of buoyancy to systems that were facing supply bottlenecks of different kinds. Here again the effect is temporary and can, in fact, generate new problems, such as increased urban-rural inequalities, that can impact adversely on poverty. Finally, the relaxation of price controls and new freedoms to pursue profitable investment opportunities, however small, can result in an investment surge.

The first issue that needs to be clarified is whether, growth which may be a necessary precondition for poverty reduction, is a sufficient condition for the same. For example, Chen and Ravallion (2000) suggest that the 1990s did not see much progress against consumption poverty in the developing world, despite the fact that “this was a period of aggregate economic growth.” While, the overall rate of growth in real per capita private consumption for the low- and middle-income countries over 1990-97 was 2.6 per cent per year (World Bank, 2000a), the elasticity of the aggregate ($1/day) poverty gap in 1987 was –2.3. “Even assuming no growth from 1987 to 1990, an annual rate of growth in mean consumption of 2.6 per cent over 1990-97 alone would have virtually halved the aggregate poverty gap.”

Rising inequality appears to explain this discrepancy. Simulations in Ravallion et al. (1991) indicated that a four percent increase in the world’s Gini index, spread over 15 years from 1985, would be sufficient to wipe out the gains to the poor from a sustained
one percent per annum rate of growth in consumption per capita. The evidence in Milanovic (1999) points to a sharp rise in inter-personal income inequality in the world during this period with the world Gini index increasing by 5 per cent between 1988 and 1993 (from 0.63 to 0.66). This could easily have wiped out the gains to the world’s poor from global economic growth.

*The Chinese experience*

Evidence from individual countries also points in the same direction. The two countries that have the largest population and the largest number of the poor, namely China and India, were also countries that registered high or creditable rates of growth by international standards during the 1990s. However, poverty reduction in both countries was not as expected. Here again persistent or rising inequality was a factor neutralising whatever positive effect that growth in these countries had on poverty reduction.

Though recent data on inequality in China is difficult to come by, the available evidence does suggest that the years of reform were ones of worsening inequality in China. As Bouche et. al. argue in their country study, China’s economic reforms seem to have led up to an increase in regional inequality. “The urban-rural income disparity has been widening since the first five or six years after the economic reform in 1978,” they note. Official statistics indicate that the income ratio of urban residents to rural increased from 2.4 in 1978 to 2.8 in 2000. Other analysts corroborate this observation. Before the start of reform in 1978, the ratio of urban to rural income had declined to 2.36 from 3.48 in 1978. Price and production reform in agriculture ensured that this trend continued till 1985. However, after 1985, the ratio began to rise again and stood at 2.61 in 1994. Further, within rural and urban areas the gini coefficient of income distribution rose from 0.31 and 0.19 respectively to 0.41 and 0.37 between 1986 and 1994 (Zhang 1996: p. 21 and Table 18). This worsening of income distribution, which appears to have continued since then, has neutralised some of the significant benefits in terms of poverty reduction ensured by the rapid rates of growth in aggregate income China has managed to ensure since the beginning of the reform.

One reason for this is the priority given to coastal development from the early 1980’s to the late 1990’s. In order to attract investment to the coastal regions, the government provided a range of incentives, though these regions were already more advanced than the rest of China. In the event, the slow and inadequate development of the central and western regions, where much of China’s poor are concentrated, became an obstacle to reducing poverty in these provinces.

The evidence from some other countries also suggests that economic liberalisation or neoliberal economic reform can also lead to increasing inequality, adversely affecting the poverty reduction effort. The adverse effects of rising inequality resulting from the process of structural adjustment and reform are visible in a country like Pakistan. The move to encourage exports during the 1980s, with the removal of export restrictions, devaluation of the currency and provision of a range of export concessions to the textile sector, did result in a rapid expansion in textile exports. As a result cotton textile
manufactures such as yarns, fabrics, apparel and clothing accessories, which accounted for 35 per cent of Pakistan’s exports in 1980, registered an increase in share to 75 per cent in 1998. The profitability and rapid growth of these exports rendered cotton cultivation an extremely lucrative activity, resulting in resumption and leasing in of land for self-cultivation by large farmers. Cotton output tripled between 1980 and 1992. Simultaneously, farm holdings of size greater than 50 acres, which accounted for 0.3 per cent of farms and 8.4 per cent of area in 1981, came to account for 8.4 per cent of farms and 23.8 per cent of area. The rural gini coefficient is estimated to have risen from 0.32 in 1978-79 to 0.41 in 1990/91 (Eken, S. et. al. 2001: 100-104). This increase in inequality would have adversely affected progress on the anti-poverty front. Further, this inequality would have made the consequences of the slowdown of growth in the 1990s particularly adverse for the poor.

Overall, the inter-temporal record with regard to poverty decline in China has been uneven during the reform years. Between 1978 and 1985, when the household responsibility system was introduced in rural areas, not only were the incentives to invest directly advanced, but they were supported by greater availability of crucial inputs like fertilisers and spurred by increases in procurement prices. This triggered rural economic growth, helped reduce rural-urban inequalities as argued earlier, and contributed to a reduction of rural poverty. During this period, official estimates suggest that the number of rural poor fell by 125 million. Clearly, macro policies stimulating rural growth were pro-poor in nature.

The process was, however, halted between the mid-1980s and 1992, when rural poverty stagnated. These were the years when the government focused on growth in the coastal regions and reduced investment in agriculture. The adverse effect this had on poverty reduction was aggravated by changes in financial policies that altered lending priorities of poverty alleviation programs after 1988. In 1988, the PADO changed its lending targets from households to enterprises and other “economic entities” and this was accompanied by a fall in real terms of funds available for poverty alleviation.

Possibly recognising this, after 1992 the government increased resources available for poverty alleviation in poor areas, relaxed controls on interregional mobility of labor and adjusted in 1996 the targeting policy by shifting its focus from poor regions to poor villages and poor households. Also, priority was given to the development of the backward central and western regions where much of the poor population is concentrated and, in the middle 1990s, raised farm prices raised substantially. Interestingly, “virtually the entire fall in rural poverty by the $1/day definition in the 1990s occurred in the middle three years of the decade, when farm prices were rising sharply.”

Food prices and poverty

It must be noted that an increase in agricultural prices is not necessarily always positive. It could contribute to an increase in poverty incidence in situations characterised by substantial inequalities in land ownership and significant degrees of landlessness. In such contexts, what needs to be looked at is not just the nominal price level of food, but the
relative price of food and the rate of increase of nominal food prices. A faster rate of increase of agricultural prices can have two contradictory effects on poverty. First, to the extent that agricultural growth is stimulated by a shift in terms of trade in favour of agriculture, and assuming that inequality does not increase, the rise in agricultural prices would contribute to a reduction in rural poverty to some extent. Second, since all urban workers and a large part of the rural population, consisting of agricultural labourers, small farmers and non-farm workers, are all net purchasers of food, a sharp increase in the price of food would squeeze real incomes and worsen poverty.

This dual effect on poverty of higher agricultural prices has implications for those who emphasise the importance of “getting prices right” through integration into the global economy. These economists have traditionally argued that protection in developing countries, which in all cases has been exclusively provided to or concentrated on industrial goods, was indefensible on grounds of both “efficiency” and “equity”. In their view, protection for industry and none for agriculture has in the past tended to skew the industry-agriculture terms of trade in favour of industry. This is seen to have adversely affected incentives for investment in agriculture, resulting in slow agricultural growth that limited poverty reduction or even worsened rural poverty. Liberalisation, by reversing the skewed structure of incentives, it is argued, would spur agricultural growth and reduce poverty.

What this argument, given its exclusive emphasis on growth ignores, is the adverse effects on poverty that higher food prices can have. So long as the prices of food do not rise faster than rural money wages and the prices of non-food agricultural products, the growth effect of higher agricultural prices would manifest itself and impact positively on poverty reduction. However, in practice the liberalization of agricultural trade by subjecting non-food agricultural crops to international competition and by displacing domestic jobs keeps the prices of the former down and dampens money wage increases. On the other hand, shifts of acreage out of food into non-food crops and the release of controls on food prices after liberalization, could increase the price of food. In such an event, policies of stabilisation and structural adjustment worsen poverty, by neutralising whatever positive effects any increase in agricultural growth may have.

*Agricultural growth, non-agricultural activity and poverty*

However, agricultural growth and inequality trends do not capture all influences on the level of poverty incidence. In India, for example, the proximate role of inequality in worsening poverty or limiting gains in terms of poverty reduction has conventionally been situated in arguments that point to a complex combination of influences on poverty in predominantly rural communities (Sen 1996: pp. 2459-77). The Green Revolution of the 1970s and 1980s, while leading to increases in agricultural output per capita, was characterised by some increase in concentration of operated area and marketed surpluses, as well as a substantial increases in regional inequalities in agricultural production. Yet, the incidence of poverty during these years was declining significantly, forcing researchers to look to other factors that could explain the decline in rural income poverty.
This decline was all the more surprising because evidence indicated that the output increases during the Green Revolution years and later were accompanied by a decline in the output elasticity of the demand for labour in agriculture. There seemed to be one factor which was neutralising the effect of these trends, viz. a rise in agricultural wages, which was then seen as an important influence on poverty. But why were real agricultural wages rising, if employment in agriculture was inadequately responsive to agricultural growth? The empirical answer seemed to lie in a substantial increase in rural non-agricultural employment. Over the 15-year period from 1972-73 to 1987-88, the share of rural male non-agricultural employment in total rural male employment rose by 9 percentage points and that of female non-agricultural employment in total rural female employment by 5 percentage points. This seemed to make the growth of rural non-farm activities and rural non-farm employment an important cause for reduction in rural poverty.

On similar grounds we should expect that China’s successful reliance on town and village enterprises would have increased rural employment and contributed to a reduction in poverty. China was served well by a combination of egalitarian land distribution and experience with commune and cooperative forms of organisation, which helped release and pool labour resources for undertaking non-agricultural activities that were jointly managed with State support. To the extent that economic reform, especially the reform of financial policies adversely affected the growth of the TVEs, it would have set back the poverty reduction effort as well.

Reforms in China impacted on urban poverty as well, by generating unemployment through the restructuring of the state-owned sector in a context where the social security system was weak or absent. Bouche et al. argue that urban poverty is closely associated with inability to work, and that the increase in urban unemployment as a result of market-oriented reforms and withdrawal of financial support for ailing state enterprises, has been a prime cause of the increase in urban poverty. Prior to the restructuring of the state-owned enterprises (SOEs), there was no great variation in urban poverty among regions due to guaranteed employment and the ubiquitous urban welfare system. This even regional pattern changed when market oriented reforms that restructured the SOEs and weakened the social welfare system. The decision to restructure before putting in place a social safety net proved to be a mistake. This is corroborated by the fact that the change over time in the regional distribution of urban poverty was highly correlated with the original structure of industry and with regional economic growth. Poverty was higher in regions were the heavy industries set up during the era of central planning were concentrated.

Moreover, the urban poverty reduction effort has increasingly shifted away from providing direct income support to workers retrenched from public enterprises, to provision of unemployment insurance for those eligible to register as unemployed and minimum living standard payments under a scheme that has widely varying standards of eligibility and payment according to locality. This shift too, could have diluted the effort to neutralise the poverty-inducing effect of SOE reform.
Finally, financial stringency resulting from the fiscal framework applicable to or adopted at various levels of government can limit the poverty reduction effort. In China, most poverty reduction programs financed by the central government and by international donors require counterpart funds from local governments. On the other hand, most local governments in poor counties face severe budgetary constraints. As a result an auditing report provided by the State Auditing Bureau indicated that 370 out of 592 poor counties had not provided any counterpart funds from 1997 to 1999. The problem is similar in urban areas, since many city and town governments lack the fiscal resources to provide counterpart funds for financing the new unemployment, pension and medical insurance systems.

**Vietnam**

Vietnam is another case where the transition triggered a process of high growth. Even before the stabilisation programme of 1989, Vietnam's GDP growth rate was quite high for countries in transition, averaging 5 per cent during 1986-89. Since export growth revived, growth was accompanied by a comfortable balance of payments position as well. Over 1985-1988, the trade deficit averaged almost 100 per cent of exports, since the value of imports was double that of exports. However, during 1990-1992, it fell to an average of less than three percent of exports and accounted for less than one percent of GDP. This was ensured by dramatic increases in the exports of marine products, rice, and petroleum, among which exports of the latter two products were close to zero in 1985-1986. Since this was accompanied by capital inflows that exceeded the deficit on the balance of trade, Vietnam’s external position was comfortable.

Even after 1989 growth remained respectable and well above that of many of the so-called High Performing Asian Economies. The rate of growth was slightly less than seven percent during 1995-2001, so that GDP per capita grew at just below five percent. The fact that the rise in exports helped finance required imports must have also contributed to the remarkably low rate of inflation of around seven percent per annum measured by the GDP deflator during the 1990s. That figure fell to three percent in 2000.

Given the high degree of egalitarianism that characterised asset and income distribution before the reforms, this rate of growth was accompanied by a substantial decline in the incidence of poverty. The Vietnam Living Standards Surveys relating to 1993 and 1998 point to an across-the-board reduction of poverty in the country, despite an increase in inequality due to the effects of market-oriented reforms. This was because, while the Gini coefficient rose only modestly from 0.33 to 0.35, whereas growth during the 1990s averaged 7.2 per cent a year and that during 1993-98 was even higher.

To the extent that the exhaustion of the once-for-all growth-inducing effects of market-oriented reforms and changed in international circumstances would make it difficult to sustain the high growth rates of the 1990s and the inequalising effect of those reforms assert themselves, it is possible that the rate of poverty reduction could slow or even reverse itself. This is all the more likely because the evidence seems to suggest that the restructuring of the state-owned enterprises is resulting in unemployment as a result of which the responsiveness of employment growth to growth in industrial output is
extremely low. Thus policies aimed at ameliorating the inequalising effects of reform and generating additional employment in the non-agricultural sector would be crucial if growth is to be pro-poor in Vietnam. This, therefore, should be the principal concern of macroeconomic policy.

Mongolia

Unlike Vietnam, Mongolia is a case of a small economy in transition where the process has had adverse implications for growth, and consequently for the poverty reduction effort. It was in 1990 that Mongolia began its transition with a package of policies typical of the shock therapy seen by some as needed to galvanise the erstwhile centrally planned economies. However, the record after that has been dismal. Real output fell by 22 per cent between 1989 and 1993. And though it recovered to record an annual growth rate of less than 3.5 per cent over the next seven years, by the end of 2000, GDP was still nearly four per cent lower than it had been more than a decade earlier. In other words, over the transition period as a whole the growth rate was roughly zero. In 1999, per capita income was 77 per cent below what it was in 1989.

One factor accounting for the collapse in real incomes was rapid liberalization of price controls, which resulted in high rates of inflation that at its peak immediately following reform in 1992 stood at 325 per cent. However, though hyperinflation was brought under control with a tight monetary policy, that policy restricted nominal and therefore real income growth. Griffin et. al. point out that “rates of interest were highly negative in the early years of the transition (when inflation was very rapid and the monetary authorities lost control of the supply of money), but in the later years (when monetary policy was very tight) real interest rates in the formal banking system became so high that they almost certainly inhibited investment, thereby slowing the rate of growth and damaging the prospects for a reduction in the incidence of poverty.”

Mongolia was doubly handicapped by the reform because as a result of the transition public expenditure fell rapidly. In 1999 government expenditure was only 51 per cent of its level in 1989. This was because GDP fell and investment as a share of GDP declined from 50.2 per cent of GDP to 26.9 per cent; that is, the share of government expenditure fell by 46.4 per cent. In the event, the government’s ability to sustain demand, crowd in private investment, provide social services such as education and health and combat poverty had been massively eroded.

During the 1990s there were also indications of a worsening of Mongolia’s underdevelopment as a result of a process of deindustrialization, and a sharp increase in those employed in the agriculture and livestock sector. Agriculture’s share of GDP rose from 14.1 per cent in 1991 to a peak of 43.8 per cent in 1996. This coincided initially with a collapse of GDP generated by construction, trade, transport and communications and services, and then in industrial output. Within agriculture there was a growing specialisation in livestock, with its share in agricultural output rising from 70.1 per cent in 1989 to 90 per cent in 1999. This shift was not accompanied by productivity increases in the agricultural sector, indicating that the latter was a sink for poverty and that the country was going through a process of agricultural involution as a result of the reform.
The result of all this was there was no advance whatsoever on the poverty front. The evidence reveals that the proportion of population below an appropriately adjusted poverty line rose marginally from 51.6 to 51.7 per cent between 1995 and 1998.

**Cambodia**

Cambodia is another instance of a small, least developed, economy in transition that has not seen any significant reduction in poverty as a result of the shift to a more market-driven regime and the adoption of typical IMF-style stabilisation and adjustment strategies. The Cambodian case is exceptional because the transition, which began with the signing of a peace agreement in 1992, came after three decades of war and political instability. In fact the political instability persisted even after 1992 and more or less normal development can be dated to 1998, when all parts of the country were accessible. The devastation of the economy in the years preceding 1992 was accompanied by massive displacement of the population, making the country extremely dependent on international aid for its revival.

Thus the nature of the transition was determined in large part by the donor community and the process of development during the transition was influenced by the presence of that community and the large dollar expenditures it undertook. In particular, Cambodia was subject to an implicit process of dollarisation with many transactions in the urban areas, particularly in the capital Phnom Penh, being denominated and paid for in dollars.

The demands generated by aid and expatriate expenditures helped trigger a creditable rate of growth of GDP measured in riel of around 5.7 per cent per annum between 1993 and 2001. However, growth of GDP measured in dollars stood at just 1.1 per cent and per capital dollar incomes fell from $251 to $197, while the riel figure rose from 691,000 to 774,000.

This pace of growth was obviously inadequate to make much of a dent on poverty, which is placed at 40 to 45 per cent of the population and showed no improvement between 1993-94 and 1999. This is not surprising since real average per capita consumption by all strata of the population fell between 1993-94 and 1999, from 2,260 riels per day to 1,800. Persisting or possibly rising inequality appears to be responsible for this trend. Three surveys spread over the 1993-99 period suggest that the poorest decile of the population shared 3 per cent of total income while the richest decile garnered over 30 per cent. Inequality is consistently higher in Phnom Penh and is slightly less marked in rural areas with the poorest and richest decile figures estimated at 4 per cent and 20 per cent respectively.

Dealing with inequality requires focusing on the “self-employed” in agriculture since over 71 per cent Cambodia’s poverty, according to the CSES 1997, is in households whose heads work in agriculture. Earnings from self employment are on average equal to 61 per cent of total income, and two-thirds of this derives from activities related to cultivation, livestock, fish raising, and forestry and hunting.

Beyond a point however the solution lies outside agriculture because cultivable land is sparse relative to population. An overwhelming share of the rural population is
concentrated on 30 per cent of the country with only a quarter of the area cultivated. Non-farm employment therefore holds the key to poverty reduction.

In practice, growth during the 1990s has expanded non-agricultural opportunities. But this has been concentrated by sector and location. Much of the growth, as much as 94.5 per cent, has been accounted for by the garment industry. Taken together, the apparel industry, construction, transport and communications, and the tourism-related sector of hotels and restaurants have increased their share of GDP from 16.9 to 27.5 per cent of GDP.

Liberalization in a donor-driven environment has accounted for this pattern of growth. Donor policy is to build capacity with technical assistance while allowing growth to be driven by the private sector. But such growth has not just been concentrated in Phnom Penh but is vulnerable to changes in the global trading environment given its dependence on the garment sector.

Poverty reduction policy is focused on human resource development and provision of better health services, so as to improve the capacity of the population to benefit from the new opportunities. In addition there is some emphasis on micro-credit schemes that are expected to both mobilize the savings of the poor and to provide credit to them on terms that are more favourable than those available either from the formal banking system or informal money-lenders. Unfortunately this strategy has neither helped adequately raise the rate of growth or make it broad-based enough to impact favourable on poverty.

The diversity in experience
In sum, the experiences of the four countries in transition covered by the country studies vary substantially. While the transition triggered growth in China and Vietnam, it delivered little growth or contraction in Cambodia and Vietnam. This has obvious implications for policy relating to poverty reduction. In China and Vietnam, the thrust of policy should be to sustain reasonable, if not high rates of growth, and ensure that the pattern of growth, increasing inequality and the effects of industrial restructuring do not limit or neutralise the poverty-reducing effects of that growth. From the point of view of sustaining growth it is necessary to ensure that tight monetary policies and stringent liquidity conditions combine with a deflationary fiscal stance do not emerge as constraints. In addition, financial policies should not be such as to worsen regional and income class inequalities or as to limit the expansion of sectors that can contribute to poverty reduction.

In Cambodia and Mongolia on the other hand, reviving growth appears to be a pre-condition for poverty reduction. Even there, however, it is important to ensure that deflationary monetary and fiscal policies or financial policies that are inequalising or detrimental to the growth of sectors that are “poverty sensitive” are not adopted.

2.2 Mixed, Market-Driven Economies

The mixed, market-driven economies display tendencies similar to the transition economies. However, initial conditions play a role that differentiates their experience to a
significant extent. First, inequality in asset and income distribution tends to be far greater in these economies, as a result of which the “trickle-down” effects of growth on poverty alleviation can be neutralised to a far greater degree. Second, being home to a much larger number of institutions that are privately owned and controlled, these economies reflect the adverse consequences of market-driven development on poverty to a far greater degree. Finally, starting from a situation in which state intervention substantially takes the form of regulatory control over private decision-makers, liberalisation here involves the dilution of regulation itself. As a result the worst excesses of marketism are seen here to a far greater degree than in the economies in transition.

*Growth, inequality and poverty reduction in Bangladesh*

Interestingly, however, Bangladesh provides an instance where an increase in inequality during the 1990s was accompanied by a reduction of poverty because of a high pace of expansion of aggregate consumption and GDP. The Gini ratio for rural areas rose from 0.26 to 0.30 between 1991-92 and 2000 while that for urban areas rose from 0.32 to 0.38. Osmani *et al.* attribute this increase to the unequal distribution of non-farm and remittance income. However, despite increasing inequality, the proportion of population living below the poverty line declined from a high of 71 per cent in 1973/74, which is the earliest figure available, to 40 per cent in the year 2000. What is more, the pace of poverty reduction appears to have accelerated during the 1990s compared to the 1980s, with the head-count ratio falling marginally from 52 per cent in 1983/84 to about 50 per cent in 1991/92, and then declining sharply to 40 per cent by 2000.

Accelerated economic growth, albeit from a relatively low level, appears to have played a major role in reducing poverty. From a level of around 1.6 per cent per annum in the 1980s, the rate of growth per capita GDP accelerated to 2.4 per cent in the 1990s. Within the 1990s too, the rate of growth accelerated from about 1.6 per cent per annum in the first half of the 1990s and to 3.6 per cent in the second half of the decade.

According to Osmani *et al.*, the demand stimulus generated by a quantum jump in crop production starting the late 1980s, export-led growth in the readymade garments industry and workers remittances from abroad, contributed to the acceleration in growth. Of these the first was the overwhelmingly dominant factor, with garment exports and remittances playing some role in the second half of the 1990s. Interestingly, much of the growth was accounted for by the non-tradable sectors, especially services.

Besides the level of growth, the pattern of growth seems to have helped reduce poverty. The growth process of the 1990s was characterised by faster growth of the rural non-farm sector, whose significance from the point of view of poverty reduction has been discussed earlier. Moreover, there was a change in the nature of rural non-farm employment in the 1990s when compared to the 1980s.

It must be noted, however, that the growth of rural non-agricultural activity and employment can be the consequence of three different factors, not all of which were conducive to poverty reduction. First, some part of non-agricultural employment is seen as the result of the distress-driven spill-over into inferior, low productivity and low-wage
non-agricultural activities of a surplus labour that cannot be sustained by a slow growth in agriculture and a low rate of labour absorption in agricultural activities. In this case rising non-agricultural employment is a result of poverty rather than a factor that can contribute to its alleviation. Second, in some contexts and regions, non-agricultural employment was seen as the direct result of agricultural growth, which results in a range of demands for non-agricultural services such as agro-processing, repair services, storage and transportation. Increases in agricultural output per capita can also result in demand for certain labour-intensive manufactures, if institutional conditions are such that the increments to income are not concentrated among the very poor (who would spend those increments on food) or the rich (who would divert such incomes to purchases of urban-based capital-intensive manufactured goods). If these are the factors, spurring growth in rural non-agricultural activities, then there is a virtuous nexus between agricultural growth and non-agricultural employment, with extremely positive results in terms of poverty reduction. Finally, a significant part of the impetus for growth in non-agricultural activities could come from outside the rural sector, mediated in large part by government expenditure on the provision of extension services, on social service provision and on employment generation. That is rural incomes are no longer based on or derived only from agricultural production, but by the specific forms in which rural areas are being integrated into larger macro-economic decisions regarding expenditure. If such decisions favour larger expenditure on rural non-farm activities, the effect on poverty alleviation is likely to be positive.

During the 1980s in Bangladesh, the rapid shift of labour force into the rural non-farm sector was predominantly a shift into self-employment at the lower end of the productivity scale. As opposed to this, the 1990s were characterised not only by a rapid shift into the rural non-farm sector, but also by faster growth of relatively larger-scale enterprises that are more productive and employ more wage labour. The increased options for wage employment this implied would have impacted positively on poverty since it does not imply a distress-driven spill-over into overcrowded petty small-employed activities.

These features of the growth-poverty reduction nexus in Bangladesh have important implications for macroeconomic policy, including policies relating to the financial sector. To start with, given the crucial role of demand-driven growth, such policies should enhance rather than undermine the process of demand expansion in the economy. Secondly, those policies must sustain the shift into relatively larger-scale rural non-farm activities, so that the positive employment implications of that shift can be increased. Both of these would require both a high level of public expenditure, in rural infrastructure for example, and easy access to credit for small-scale rural industry.

A garment-led, export-oriented strategy cannot be a substitute for this inasmuch as the relatively small size of that sector implies that even high growth cannot make too large a contribution to overall GDP and employment growth and given the possible loss of export markets in the area once the implementation of the Uruguay Round agreement on trade in textiles is fully implemented by 2005.
**The Indonesian case**

The role of the sectoral, organisational and technological characteristics of growth in influencing the pace of poverty reduction comes through in the Indonesian experience as well. In addition, the country study illustrates how the process of financial liberalisation, by affecting the fiscal stance of the state as well as by increasing the fragility of the financial system and precipitating a crisis worsens the poverty situation.

Indonesia’s experience with poverty reduction between 1976 and 1987 was indeed remarkable. According to one estimate based on expenditure data, the proportion of the population in poverty fell from 40.1 per cent to 17.4 per cent (or by 57 per cent) during this period. Other estimates, while suggesting a higher incidence of poverty, point to a similar reduction. Thus, a study by the United Nations Support Facility for Indonesian Recovery (UNSFIR), (Dhanani and Islam 2000), estimates that poverty fell from slightly less than 69 per cent in 1976 to almost one third in 1996.

The point to note is that this dramatic reduction in poverty was not just because of a high rate of growth but was also influenced by the pattern of growth (Ikhsan 2002). That pattern, in turn, was influenced by state policy. In the 1970s and early 1980s, the government advanced agricultural growth and rural development by promoting green revolution technologies, ensuring access to fertilizers and pesticides, providing cheap credit, guaranteeing stable prices and investing in physical infrastructure like irrigation and roads. As a result, the agricultural sector experience rapid and widespread growth of output of tree crops and rice production.

In addition, the government invested substantially in social infrastructure, particularly schools and health clinics. This facilitated more widespread participation in the growth process with attendant positive effects on poverty. Needless to say, revenues from Indonesia’s oil boom and its earnings from other natural-resource exports, such as rubber, palm oil and tin, helped finance these expenditures on physical and social infrastructure. But the Indonesian experience was creditable given the evidence from some other resource-rich developing countries, which squandered the initial advantages of substantial export earnings.

However, starting in 1987, Indonesia too began adopting a policy of economic liberalisation. It can be argued that this shift in strategy would have adversely affected policies and expenditures that impacted positively on poverty. Not surprisingly the shift was accompanied by a slowing of the pace of poverty reduction. Between 1987 and 1996 the percentage of the population that was poor did fall to 11.3 per cent, but this decline of 35 per cent was lower than that recorded during the 1976 to 1987 period. Despite the deceleration, the pace of poverty reduction remained significant partly because there were certain features of the growth process after liberalisation that had positive implications for the poverty reduction effort. During this period there was a shift in emphasis from the export of primary products to the export of labour-intensive industrial products such as footwear, furniture, textiles and toys that was successful and resulted in widespread manufacturing employment among low-skilled workers, amplifying the reduction in poverty. Further the rapid rates of growth of the agricultural and industrial sectors led to
overall buoyancy in the economy that expanded the number of the service sector jobs in both rural and urban areas.

However, liberalisation had two adverse consequences. First, it undermined the role of credit in development policy and diluted the public expenditure effort, resulting in the loss of two major stimuli for growth. Second, through a process of financial liberalization it changed the rules of the game in the financial sector and paved the way for the financial crisis of 1997. As a result, while Indonesia’s track record suggested that it was capable of evading the contagion effects of the financial crisis triggered by the run on Thai bhat in 1997, when speculators turned their attack on the Indonesian rupiah that year, the speed and severity of the financial crisis that ensued surprised everyone. The consequences were also dramatic. The growth rate of GDP fell by almost 18 percentage points, from a positive 4.7 per cent in 1997 to a negative 13.1 per cent in 1998. This was partly because the effects of the crisis were exacerbated by a severe drought, which drove up food prices, took the rate of inflation to 60 per cent in 1998 and substantially eroded the real incomes of the poor. Further, the prices in 1997 for Indonesian exports, such as oil, fell sharply squeezing domestic demand even more.

In the event, at the highest point of the crisis, income poverty had roughly doubled compared to its level in 1996. Based on a revised methodology the Central Bureau of Statistics (CBS) arrived at a higher estimate of income poverty. The new estimate for 1996 was 17.7 per cent instead of 11.3 per cent. By September of 1998, estimates based on the new methodology indicated that 38.7 per cent of the population were poor. World Bank estimates for 1996 through 2001 reflect a similar trend. And, the Dhanani and Islam estimates show that poverty did increase markedly during the crisis (by about 50 per cent) but not as dramatically as shown by the CBS and World Bank estimates.

**Nepal: A small least-developed country’s experience**

Nepal is a country where two decades of liberalization has adversely affected the already poor poverty-reduction record. Despite the fact that Nepal is a small, landlocked least developed country, it has adopted an orthodox neoliberal liberalisation package since the early 1980s. Besides orthodox stabilisation, the package involved creating the “right” incentive structure for greater private participation in economic activity, opening the economy to foreign trade and capital flows and reducing the role of the state in economic activity.

With hindsight it is clear that this policy framework was not the most appropriate from the point of view of reducing the incidence of poverty. While reliable and comparable estimates of poverty incidence are hard to come by, the available evidence suggests that around 45 per cent of the population live below the poverty line. Further, it appears that the proportion of people below the poverty line increased by close to 10 percent between 1977 and 1996. The number of poor people, therefore, almost doubled, from about 4.9 million in 1977 to about 9.5 million in 1996.

With 80 per cent of the population cultivating some land and 50 per cent deriving their incomes from agriculture, it is not surprising that poverty in Nepal is a predominantly rural phenomenon. This makes agricultural growth and the generation of rural non-farm
employment crucial from the point of view of poverty reduction. Yet in the post-reform period agricultural growth at 2.2 per cent was lower than the rate of population growth, and growth during the first half of the 1990s was lower than that during the 1980s.

Besides the pace of growth, asset inequality has also ensured that the impact of growth on poverty is limited. Land distribution in Nepal is highly skewed, with around 43 per cent of holders owning less than 0.5 hectares of land in 1991 and accounting for only 11 per cent of total cultivated land. On the other hand, the top 10 per cent of households, who own 3 hectares or more, account for around 42 per cent of the total cultivated land. But the role of inequality should not be exaggerated since given the terrain in parts of the country even medium and ‘large’ landholders are in poverty. This makes investment in land and irrigation, which would help increase productivity, crucial to poverty reduction. The poor state of physical infrastructure (including roads) and social infrastructure aggravates the poverty problem. Only 35 per cent of the cultivated land in the country is irrigated to some degree even for one season in the year. Further, there is strong evidence of an inverse relationship between the access to roads and the severity of poverty.

Given all this, investment aimed at boosting growth, especially agricultural growth, is crucial for poverty reduction. However, with stabilisation and structural adjustment involving limiting the role of the state, investment increases came to depend on the private sector. Not only was private investment inadequate in the agricultural sector but overall private investment tended to decelerate after the mid-1990s because of the lack of a demand stimulus and because of the strong crowding in effects that public investment has on private investment in the agricultural sector.

As the Nepal country study makes clear: “Given high levels of risk and uncertainty and imperfect knowledge and information, investment in the agricultural sector has many ‘public good’ features.” This makes poverty reduction crucially dependent on “strategic investments by the state to provide key inputs and to promote broad based agricultural growth, which will have a positive effect on rural incomes.”

Above all, besides access to land, access to credit is a key determinant of productive investment in agriculture. Rural credit markets in Nepal are in any case predominantly informal, accounting for around 80 per cent of total rural credit. These markets are often exploitative, are characterised by extremely high interest rates and act as a deterrent to new investment in agriculture. Unfortunately, economic reform has involved the reduction of even the limited amount of formal credit available in rural Nepal and an increase in the urban bias in credit availability.

3. Poverty and vulnerability

Overall, the evidence from the case studies suggest that economic reform, which includes varying degrees of financial liberalisation in countries with differing financial regimes to start with, has affected the pace of poverty reduction adversely and on occasion has even worsened poverty. This reversal suffered in the war against poverty is all the more significant because of the extreme vulnerability of the population in many of these
countries in the face of shocks of different kinds varying from natural calamities such as
droughts, floods and earthquakes to man-made shocks like the financial crisis in East
Asia. In most natural calamities, whether they are typhoons in the Pacific, floods in
Bangladesh, or earthquakes or droughts in India, it is the poor that are affected most
adversely. They are the ones who are located in the most calamity-prone areas, live in the
most vulnerable shelters, are prone to crop and employment loss in times of crisis and
have no safety nets to fall back on when adversely affected. Further, already being at the
margins of subsistence, even a small external shock is sufficient to push them into a
situation where survival is in threat. For these reasons poverty and vulnerability are
inextricably intertwined.

But as recent experience indicates, it is not just the extremely poor who are vulnerable.
East Asia, including some of the more successful East Asian performers, witnessed a
reversal on the poverty alleviation and human development fronts during the late 1990s
as a result of the financial crisis. It is now widely accepted that, though triggered by a
slowdown in exports and widening current account deficits, the crisis was the result of
the activities of a few financial entities, which in the wake of financial liberalisation
exploited interest rate differentials to engage in speculative investments, including in real
estate and stock markets. This resulted in huge commercial losses and bankruptcies, and
the real economic crisis that ensued had devastating effects across the East Asian region.
Slow growth, unemployment and worsening human development among the poorer
sections were the end results.

Growth in the main countries affected by the crisis collapsed as a result of asset deflation,
the liquidity crunch, bankruptcies, and the consequent collapse of investment. An
immediate consequence was a sharp rise in the unemployment rate. The unemployment
rate rose from 4.9 per cent to 6.1 per cent between 1996 and 1999 in Indonesia, from 2
per cent to 4.1 per cent in Republic of Korea, from 7.4 to 9.6 per cent in the Philippines
and from 1.1 to 4.2 per cent in Thailand.

This together with a host of developments that occurred in these economies soon reversed
their successful record on the poverty reduction front. Using poverty lines appropriate to
each of the countries, we can detect a sharp increase in poverty in all the crisis-affected
countries. What is more, the slow growth in these crisis-affected countries, in a region
that is substantially integrated through trade and foreign capital flows, spilt over to
neighbouring nations, resulting in the slowdown of poverty reduction in East Asia as a
whole.

Some Implications for Policy

Our discussion of the proximate determinants of poverty trends has a number of
implications with regard to the macroeconomic environment suited to poverty alleviation
and the policies appropriate to realising such an environment. The first, overarching
implication is that growth is a necessary precondition for poverty reduction in less
developed economies, and should be a priority for macroeconomic policy. This makes
raising and sustaining the rate of investment the central developmental problem in most
contexts. This is a perspective that dominated development economics since its inception
and was the focus of the United Nations’ *Measures* document. It was only in the 1960s and after, that the concern with investment allocation and questions of “efficiency” came to influence the development debate, leading to the marketist prescriptions that underlie the liberalisation agenda.

The second implication is that, given the extent to which private decisions are responsible for investment, the state must support policies that strengthen the inducement to invest for the private sector. For example, state investment may be required not just to close infrastructural gaps and ensure the adequate availability of crucial inputs for industry and agriculture, but also to directly and indirectly (through its multiplier effects) stimulate demand and induce private investment. Further, in some sectors, such as investment in irrigation, private investment may be complementary to public investment. Finally, in certain situations, state coordination and investment may help trigger export growth that also serves as an inducement to invest.

Third, associated with every rate of investment is an implicit allocation of investment, given the level of access to international liquidity. State intervention may be necessary to ensure that the allocation of investment is such as to help realise or approximate the optimal composition of output needed to maximise the rate of growth. To the extent that market signals are an inadequate basis for the realisation of such an allocation, intervention aimed at influencing investment allocation is necessary.

Fourth, the allocation of investment is also important from the point of view of poverty reduction, with investments in agriculture and small-scale industrial production (especially rural) likely to impact more favourably on the level of poverty. Interventions to direct investments to these sectors may be necessary from the point of view of the poverty reduction effort, even if this involves some sacrifice of the overall rate of growth that can be achieved. Financial policies such as directed credit and differential interest rates may be crucial for this purpose.

Fifth, inasmuch as income inequality and increases in such inequality neutralise some of the effect that growth can have on poverty, the state needs to include the reduction of asset and income inequality among its primary objectives. This implies that the macroeconomic policy framework should incorporate features such as institutional change and appropriate sectoral and technological choices, with the intention of making growth pro-poor.

Sixth, the greater the degree of asset and income inequality the stronger should be the effort to keep the relative price of food in check, since the evidence indicates that where net purchasers of food are large in number both in rural and urban areas, the incidence of poverty is extremely sensitive to the relative price of food.

Seventh, on the financial side, the state should undertake a resource mobilisation effort through the use of appropriate tax and non-tax measures to help finance its own expenditures as well as ensure that financial allocations are in keeping with the structure of growth required for enhancing its pro-poor character. The emphasis should be on using
domestic savings to finance domestic investments in physical and human capital, and reliance on foreign savings should focus on foreign direct investment. Further, since almost all mixed and transition economies are demand constrained systems, unless specific supply-side bottlenecks are likely to ensure that any increase in demand would immediately spell inflation, the state should not hold back on borrowing to meet its macroeconomic targets. In addition, it should not adopt a monetary policy framework that constrains demand expansion by focusing on inflation targets.

Eighth, every effort should be made to enhance and widen the access of the poor to formal credit markets. Not only are informal credit markets characterised by interest rates that are debilitating, but the evidence suggests that the high interest rates resulting from the high transaction costs associated with micro-finance schemes (which do not have the cross-subsidisation option) make them inappropriate as a means to finance productive investment.

Finally, schemes such as public works projects and food-for-work programmes, that help generate additional employment and simultaneously strengthen infrastructure (especially in the rural areas) may be crucial from the point of view of generating the non-farm employment that helps reduce poverty.

4. Financial Structures and Poverty Reduction

Our focus here is financial liberalisation and its implications for the macroeconomics of poverty reduction. Given the mechanisms through which the poverty reduction agenda can be advanced or tends to get diluted or subverted, what kind of financial structure would be most appropriate from the point of view of poverty reduction in developing countries.

4.1 The financial sector

While the process of financial growth and deepening results in the proliferation of institutions and instruments, broadly speaking the institutional structure of the formal financial sector is defined by the following segments: the commercial banking system, the specialised development banks, the non-bank financial services industry consisting of financial companies of various kinds varying from merchant banks to mutual funds, insurance companies, and intermediaries in stock and securities markets. Each of these segments and the various kinds of players within each of these segments are subject to different forms and degrees of regulatory control, with the maximum controls normally being applicable to the banking sector and the least to organisations such as the controversial hedge funds. Further, regulation defines the kind of inter-linkages that can exist between these segments by regulating the degree to which institutions originating in one segment can participate in others.

The relationship between financial structure, financial growth and overall economic development is indeed complex. The growth of output and employment in the commodity producing sectors depends on investment that expands capital stock. Traditionally,
development theory had emphasized the role of such investment. It argued, correctly, that
given production conditions, a rise in the rate of “real capital formation leading to an
acceleration of the rate of physical accumulation”, is at the core of the development
process. Associated with any trajectory of growth predicated on a certain rate of
investment is, of course, a composition or allocation of investment needed to realise that
rate of growth given a certain access to foreign exchange.

Once the Keynesian Revolution popularised the notion that the lack of adequate financial
savings cannot be the constraint on investment and growth, it appeared that the role of
financial sector in mobilizing and channelising savings was secondary and inevitably
fulfilled. As Joan Robinson put it: “Where enterprise leads, finance follows”.

Conventionally, therefore, the issue of financing for development is a question of
mobilising or creating real resources: of mobilising surplus labour (Nurkse et. al.); of
overcoming the wage goods constraint (Kalecki); or of dealing with the problem that
underdevelopment is in part the result of the lack of adequate capital stock to employ the
labour force in full and the fact that this capital stock cannot be imported because of the
foreign exchange constraint (Feldman/Mahalanobis). Finance in the sense of money or
financial assets came in only when looking at the ability of the state to tax away a part of
the surplus to finance its development expenditures, and the obstacles to deficit-financed
spending, given the possible inflationary consequences if real constraints to growth were
not overcome.

In this framework, the financial sector is seen as adjusting to the requirements of the real
sector. However, if the financial sector is left unregulated, in economies with substantial
private assets and an important role for private agents in investment decision-making,
market signals would determine the allocation of investible resources and therefore the
demand for and the allocation of savings intermediated by financial enterprises. This
could result in the problems conventionally associated with a situation where private
rather than overall social returns determine the allocation of savings and investment.

To start with, the allocation of investment may not be in keeping with that required to
ensure a certain profile of the pattern of production, needed to raise the rate of saving and
investment as emphasised by the Feldman-Mahalanobis model. An obvious way in which
this happens is through inadequate investments in the infrastructural sector characterised
most often by lumpy investments, long gestation lags, higher risk and lower profit. Given
the “economy-wide externalities” associated with such industries, inadequate investments
in infrastructure would obviously constrain the rate of growth.

While factors such as these could limit the rate of growth, the private-profit driven
allocation of savings and investment could also affect variables such as the balance of
payments, the employment elasticity of output growth, and the flow of credit to poverty-
prone sectors, which also affect the pursuit and the efficacy of the poverty reduction
effort. It could aggravate the inherent tendency in markets to direct credit to non-priority
and import-intensive but more profitable sectors, to concentrate investible funds in the
hands of a few large players and direct savings to already well-developed centres of economic activity.

Diversion of funds away from essential to luxury goods industries could result in or aggravate a wage goods constraint, leading to increases in the prices of wage goods that worsens income distribution and dampens the pace of poverty alleviation for any rate of growth. If, however, the government were to want to influence the sectors and agents to whom credit is directed and the prices at which such credit is to be provided, in order to realise a particular allocation of investment, a given rate of investment, and an income-wise and region-wise redistribution of incomes, it may choose to impose restrictions on the financial sector to realise these goals.

The importance of these features of financial policies from the point of view of poverty reduction cannot be overstressed. Further, even in developing countries which choose or are forced to choose a more mercantilist strategy of growth based on a rapid acquisition of larger shares in segments of the world market for manufactures, these segments have not only to be identified by an agency with greater seeing power than individual firms, but that agency must ensure an adequate flow of cheap credit to these entities so that they can not only make investments in frontline technologies and internationally competitive scale of production, but have the wherewithal to sustain themselves during the long period when they build goodwill in the market, which is a function of time. The state must not merely play the role of investment coordinator, but use the financial system as a means to direct investment to sectors and technologies at scales of production it considers appropriate. Equity investments, directed credit and differential interest rates are important instruments of any state-led or state-influenced development trajectory. Stated otherwise, although financial policies may not help directly increase the rate of savings and ensure that the available *ex ante* savings are invested, they can be used to influence the pattern of investment.

Such a framework is crucial because in a large number of developing countries development occurs in a mixed economy framework where private initiative and investment are significant. In others, the transition is ensuring a growing role for private agents. This implies that independent of whether the government adopts a strategy of growth based on the home market or one of protecting and building the home market while targeting in mercantilist fashion the world market, it would have to play a major role in: (i) channelising large volumes of cheap capital to the selected units: and (ii) using the leverage provided by this activity to coordinate and influence investment decisions across the industrial sector.

To play these roles the state would have to choose an appropriate institutional framework and an appropriate regulatory structure. That is the financial structure – the mix of contracts/instruments, markets and institutions – is developed keeping in mind its instrumentality from the point of view of the development policies of the state. The point to note is that this kind of use of a modified version of a historically developed financial structure or of a structure created virtually anew was typical of most late industrializing countries. Financial structures in these countries were created to deal with the difficulties
associated with late industrial entry: capital requirements for entry in most areas were high, because technology for factory production had evolved in a capital-intensive direction from its primitive industrial revolution level; competition from established producers meant that firms had to concentrate on production for a protected domestic market or be supported with finance to survive long periods of low capacity utilisation during which they could find themselves a foothold in world markets. Not surprisingly, late industrialisers created strongly regulated and even predominantly state-controlled financial markets aimed at mobilising savings and using the intermediary function to influence the size and structure of investment. This they did through directed credit policies and differential interest rates, and the provision of investment support to the nascent industrial class in the form of equity, credit, and low interest rates.

4.2 Directed credit and agriculture

Central to such a framework are policies aimed at pre-empting bank credit for selected sectors like agriculture and small-scale industry. Pre-emption, as in India for example, took the form of specifying that a certain proportion of lending should be directed at these sectors. In addition, through mechanisms such as the provision of refinance facilities, banks were provided with an incentive to realise their targets. Directed credit programmes were often accompanied by differential interest rate policies that ensured demand for credit from these sectors by cheapening the cost of credit.

Credit pre-emption aimed at directing debt-financed expenditures to specific sectors was also often mediated by the state. Besides enforcing a cash reserve ratio, the central bank in many instances requires holding a part of the deposits of the banking system in specified securities, including government securities (as is true with “statutory liquidity ratio (SLR)” adopted in India). This ensures that banks are forced to make a definite volume of investment in debt issued by government agencies. Such debt can be used to finance expenditures warranted by the overall development strategy of the government, including its poverty alleviation component.

Ceilings on deposit rates, that could affect bank profitability, often accompany pre-emption of credit and its direction at subsidised interest rates to particular sectors. These ceilings were aimed at reining in competition between banks for deposits, which in turn may lead to high-risk and high-return lending in order to realise an adequate spread. It should be obvious that the profits of banks functioning under such regulatory conditions cannot be expected to be the same as that of banks driven purely by the profit principle, since the intention behind such policies is the maximisation of the social rate of return rather than the profitability of individual banks.

4.3 Financial polices and the pattern of investment

Another important financial intervention adopted by developing countries, besides pre-emption of bank credit for specific purposes, is the creation of special development banks with the mandate to provide cheap, or subsidised, credit to selected industrial establishments and the agricultural sector. According to an OECD estimate quoted by
Eshag, there were about 340 such banks operating in some 80 developing countries in the mid-1960s. Over half these banks were state-owned and funded by the exchequer, the remainder had a mixed ownership or were private. Mixed and private banks are given government subsidies to enable them to earn a normal rate of profit.

The principal motivation for the creation of such financial institutions is to make up for the failure of private financial agents to provide certain kinds of credit to certain kinds of clients. Private institutions may fail to do so because of high default risks that cannot be covered by high enough risk premiums because such rates are not viable. In other instances failure may be because of the unwillingness of financial agents to take on certain kinds of risk or because anticipated returns to private agents are much lower than the social returns in the investment concerned.

In practice, financial intermediaries seek to tailor the demands for credit from them with their funds by adjusting not just interest rates, but also the terms on which credit is provided. Lending gets linked to collateral, and the nature and quality of that collateral is adjusted according to the nature of the borrower and supply and demand conditions in the credit market. In the event, depending on the quantum and costs of funds available to the financial intermediary, the market tends to ration out borrowers to differing extents. In such circumstances, borrowers rationed out because they are considered risky may not be the ones that are the least important from a social point of view.

These problems can be aggravated because certain kinds of insurance markets for dealing with risk are absent and because in some (especially, developing-country) contexts certain kinds of long-term contracts may not just exist. They need to be created by the state, and till such time state-backed lending would be needed to fill the gap.

Industrial development banks also help deal with the fact that local industrialists may not have adequate capital to invest in capacity of the requisite scale in more capital-intensive industries characterised by significant economies of scale. They help promote such ventures through their lending and investment practices and often provide technical assistance to their clients. Some development banks are expected to focus on the small scale industrial sector, providing them with long-term finance and working capital at subsidised interest rates and longer grace periods, as well as offering training and technical assistance in areas like marketing. Similarly, agricultural development banks, most of which are state-backed and funded, advance credit at subsidised rates to the agricultural sector, in particular to small and marginal farmers without the means to undertake much-needed investments. Given their low credit rating, these farmers are excluded from the normal lending of commercial banks and are forced to rely on “informal” sources, such as professional moneylenders, landlords and traders, at rates of interest that far exceed those charged by commercial banks.

Fundamentally of course, development banking is required because social returns exceed private returns. This problem arises because private lenders are concerned only with the return they receive. On the other hand, the total return to a project includes the additional surplus (or profit) accruing to the entrepreneur. The projects that offer the best return to
the lender may not be those with the highest total expected return. As a result good projects get rationed out necessitating measures such as development banking or directed credit. (Stiglitz)

Finally, directed credit has positive fiscal consequences. In contrast to subsidies such credit reduces the demand placed on the government’s own revenues. This makes directed credit an advantageous option in developing countries faced with chronic budgetary difficulties that limit their ability to use budgetary subsidies to achieve a certain allocation of investible resources.

The subsidized credit provided by these kinds of development banks can be seen as combining the task of promoting productive investment with that of improving asset and income distribution and generating employment in semi-urban and rural centres. The impact this can have on poverty reduction is obvious.

In sum, regulation and control of segments of the financial sector were driven by developmental and redistributive objectives and financial policies were instruments of development, even if they were not the means to directly increase savings and investment.

4.4 Financial market failure and the case for regulation

Historically, besides developmental objectives, regulation of the financial sector has also been driven by the need to prevent or reduce instances of bankruptcy of financial intermediaries that can have external effects that can lead to financial crises and contraction in the real economy.

This role for intervention is important because of the specific features of the financial sector. Economists have repeatedly stressed on the possibility of financial market failure since, in a world of imperfect information, financial markets, "which are essentially concerned with the production, processing, dissemination and utilization of information" (on the strength and reliability of agents, on the riskiness of particular ventures, etc.), tend to fail even more than the markets for commodities do. (Stiglitz 1993).

Orthodox neoclassical theory with respect to financial markets is based on two presumptions. First, it presumes that these markets are competitive in the sense that there are a large number of providers and users of financial services, such as a large number of lenders and borrowers. Competition between these providers and users supposedly ensures that transactions in financial markets occur at arms length, and that there is no collusion between providers and/or users. Second, the theory in its simplest form assumes perfect information, implying that the information available to all market participants, whether individuals or firms, is not affected by their observation of market behaviour nor by any effort made by them, including efforts to acquire more information.

The combination of access to perfect information and competition between suppliers of capital, on the one hand, and users, on the other, ensures an adequate allocation of
savings to the best projects. Neither of these presumptions is valid, however. In practice, financial markets are structurally more imperfect than the markets for goods. Financial firms canvass for customers and use interest rate or price competition, which can encourage speculative lending to warrant higher deposit rates, as well as non-price devices.

Further, financial contracts are often “incomplete”, because there are contingencies that are unforeseen or difficult to delineate. Financial intermediaries build business on the basis of reputation and relationships are substantially based on partially informed trust. (Rajan and Zingales) Not surprisingly, financial intermediaries tend to build long-term relationships with customers. In fact, such a relationship, which gives the intermediary close knowledge of the customer, may be a prerequisite for financial accommodation. The presence of a large number of financial intermediaries does not mean that a customer has as many options. Past relationships may be crucial, muting competition substantially. (Stiglitz)

Further, markets often are interlinked. Close ties are established between a financial intermediary and non-financial businesses whose sales depend on availability of credit to their customers, for example between automobile dealers and banks. (Tobin) Also, to the extent that firms that are borrowers from conventional banks are also often provided services by merchant banking entities, for new share issues for example, the firm is a client in two kinds of financial services markets. If a single intermediary provides both services to the firm, it may relax prudential norms and provide excess credit to sustain the firm when it may be vulnerable, because the intermediary as merchant banker has convinced other customers to buy into the firm and would like to retain their confidence. Factors of this kind imply that financial markets are by no means freely, let alone perfectly, competitive.

As regards the presumption of perfect information, there are two issues of relevance here. Information as a commodity has strong public good characteristics (non-rivalry in consumption and non-excludability in provision). In particular, because of the difficulty of preventing access to information and because, therefore, others may benefit from the information acquired by a firm or individual, it may not be possible to fully or even partially appropriate the returns to information. This leads in market-driven systems to an insufficient supply of information, as happens with most public goods.

Further, information costs are in the nature of fixed costs. The volume and nature of information required may not be affected by the size of a financial transaction, even if the amount spent on acquiring information is larger when the transaction is larger. This fixed-cost nature of information makes markets that are information-intensive imperfectly competitive. Firms engaged in similar activities may not find it economic to make investments aimed at acquiring the same information.

Factors of this kind, can result in a range of market failures. To start with, it may result in insufficient monitoring by market participants. Individual shareholders may refrain from investing money and time in acquiring information about managements, hoping that
others would do so instead and knowing that all shareholders, including themselves, benefit from the information garnered. As a result there may be inadequate monitoring leading to risky decisions and malpractice. Financial firms wanting to reduce or avoid monitoring costs may just follow other, possibly larger, financial firms in making their investment, leading to what has been observed as the “herd instinct” characteristic of financial players. This not merely limits access to finance for some agents, but could lead to overlending to some entities, failure of which could have systemic effects. The prevalence of informational externalities can create other problems. Malpractice in a particular bank leading to failure may trigger fears among depositors in other banks, resulting in a run on deposits there.

Disruptions may also occur because expected private returns differ from social returns in many activities. This could result in a situation where the market undertakes unnecessary risks in search of high returns. Typical examples are lending for investments in stocks or real estate. Loans to these sectors can be at extremely high interest rates because return to these sectors are extremely volatile and can touch excessively high levels in excess of 40 per cent, say. If limited liability prevails and banks accept real estate or securities as collateral, leveraged investments can spiral in periods when expectations are that stock or real estate values would rise. Speculators may find it paying to borrow at seemingly exorbitant interest rates, also because they are in a ‘heads I win, tails you lose’ situation. If their expectations with regard to stock or real estate prices are realized they book huge profits. If they are not, the burden of loss may be transferred to the lender through default on debt. This could feed a speculative spiral that can in time lead to a collapse of the bubble and bank failures.

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

4.5 Financial market intervention

These features of financial markets provide the basis for feasible government intervention that makes everybody better off. Intervention takes many forms. It protects depositors with deposit insurance. To prevent this from being misused by banks which can offer extremely high interest rates to attract depositors, forcing lending to high risk customers who are willing to pay much higher interest rates, intervention restricts price competition between banks by setting ceilings on interest rates. To reduce situations where there are conflicts of interest because a single financial intermediary is simultaneously present in more than one market, it can build Chinese walls between different segments of the financial market and require individual intermediaries to restrict their activities to
particular segments. Finally, it can regulate the investment practices of financial intermediaries so that they are not overexposed to particular borrowers, or to particular markets where expected private returns are high, but so are the risks.

*Forms and objectives of intervention*

To summarise, government’s intervene by creating financial institutions, by regulating financial institutions and markets, by influencing directly the functioning of private financial institutions, and where all else fails substituting for these institutions by directly undertaking certain financial activities such as the provision of credit.

Given the reasons for intervention described earlier, there are range of objectives which such intervention is expected to serve: improving the allocation of resources, stimulating growth, realizing redistributional objectives, providing consumer/investor protection, ensuring bank solvency, avoiding financial crises and pre-empting failure of financial intermediaries.

*Some Macroeconomic prerequisites for intervention*

It is useful to characterize these forms of intervention into two broad sets. Those that are aimed at reducing financial malpractice and guarding against financial fragility or collapse. And those that are aimed at realizing objectives such as improved allocation, higher growth and more egalitarian asset and income distribution.

Prerequisites for the first kind of intervention include a conducive institutional structure and appropriate guidelines that adequately arm monitoring institutions/agencies such as the central bank, the ministry of finance and regulatory bodies responsible for specific sectors such as the non-bank financial institutions and the stock markets. This structure and the accompanying laws/guidelines must ensure transparency, plug “loopholes” and reduces the possibility of evading prudential regulation.

Intervention of the second kind presumes, of course, that there exists an area of control within which the state is in a position to influence the level and allocation of investment and therefore the pace and pattern of growth. Ensuring that such an area of control exists implies that any development on the import trade, capital flow and currency movement front that erodes that area of control, would also weaken the effectiveness of financial policies furthering growth and distributional objectives.

While these measures may be pursued within a wide range in terms of controls over trade, capital controls and a willingness and ability to use direct and indirect (monetary) policies to stabilise the exchange rate are crucial. Countries like France in the early 1980s, with relatively liberal trade policies, lax capital controls and a regime involving a near free float of the domestic currency, realised that efforts to use fiscal policy to stimulate the system can trigger inflation, widen the trade and current account deficits, invite a speculative attack on the currency and lead to a currency collapse that subverts the reflationary effort. As one analyst discussing the highly interventionist financial policy regime adopted by Japan after the Second World Was put it: “A combination of international capital controls, willingness to use monetary policy swiftly to defend the
currency, and the absence of other countries simultaneously following the same development strategy shielded Japan from serious problems.”

In sum, financial market intervention needs a specific set of accompanying fiscal, trade, currency management and capital control measures depending on the objectives sought to be realized by such intervention.

The critique of financial market regulation

Despite the fact that the adoption of interventionist financial regimes was not a phenomenon specific to developing countries, the years since the early 1970s have seen neo-liberal economists criticising the developing countries for adopting measures such as interest rate restrictions, limits on the expansion of credit through measures such as penal reserve requirements for banks, direct intervention aimed at limiting credit to some sectors and institutions and directing credit to others, interest rate differentials, and so on. Many such measures have been categorised under the label “financial repression”, suggesting that they are onerous and tantamount to taxing the financial system, and thus subverts the growth of an efficient financial system. The phrase “financial repression” was popularised by McKinnon and Shaw, who argued that regulated loan and deposit rates, which often resulted in negative real interest rates or rates below the prevailing rate of inflation, had adverse developmental effects, especially when combined with high reserve requirements and restrictions on the entry of new financial agents.

The mechanisms through which “financial repression” in the above form, which was also seen as an effort to divert financial resources to the government or favoured sectors, stalled growth, were nor always clear. However, a number of arguments can be gathered from the literature. To start with, repressive policies were seen as inimical to financial deepening, which was seen as positive from the point of view of economic growth given the observed empirical relationship between financial deepening and growth. In modern economies the growth of a large and diverse real sector if not accompanied by financial sector regulation could possibly lead to greater financial growth and deepening. But there are reasons to believe that financial deepening (measured by the ratio of financial to real wealth) and increased financial intermediation (measured by the share of financial assets of financial institutions in total financial assets) need not be in themselves stimuli to growth, despite myriad efforts to prove that this is true. The existence of usurious money lending in backward agriculture, that limits rather than promotes growth, is indicative of the fact that inequality of a kind inimical to growth influences the nature of a financial structure. And evidence suggests that financial crises are inevitably preceded by a phase of financial deepening and increased intermediation.

1 “Could” because a financial structure requires large fixed costs and time to set up and may take an inordinately long time to mature. It needs, for a start, the presence of an adequate number of rich individuals with the will to invest – a fortuitous combination that reportedly existed in the US when the railroads were built in the 19th century. Further, even when a structure emerges it needs liquidity to grow. This creates a typical chicken and egg problem: for agents to trade markets must be liquid, but there are no liquid markets without trading. Here again fortuitous events are required, as happened in the case of the Liberty Bonds issued in the US in the First World War, when liquidity increase was driven by patriotism. Above all, market growth is predicated on the existence of investors with well distributed preferences to but and sell particular equities. See for example, Raghuram and Zingales (2001)
Second, financial repression was seen as having a depressive effect on savings rates, and since higher savings were seen as being automatically reinvested, such repression was expected to result in capital shortages and adversely affect growth. This is seen as especially true because late industrialisation implies that modernisation requires capital-intensive investments, so that credit shortages would limit the number of entrepreneurs who can obtain access to the critical size of capital required, resulting in a low investment and growth trap. It should be clear that the view that savings are automatically reinvested and that any increase in savings leads automatically to an increase in investment is a pre-Keynesian argument with little relevance to demand-constrained economies with unutilized resources. Further, empirical studies of savings have shown that there is little relationship between national savings and real interest rates. As Stiglitz argues, while the reasons for such trends would indeed be complex, even the microeconomic theory of household behaviour would lead us to expect such an outcome, since the income and substitution effects of low or negative real interest rates work in opposite directions. Above all, the so-called “corporate veil” implies that funds do not move costlessly between the households and the corporate sector. Low real interest rates would imply a transfer from the household to the corporate sector, which can be seen as impacting positively on savings rates since the latter is expected to be characterised by a higher savings propensity than the household sector.

Finally, it has been argued that financial repression tends to selectively ration out riskier projects, irrespective of their social relevance, because interest rate ceilings imply that adequate risk premia cannot be charged. What is ignored here is that since lower interest rates increase the number of applicants from which beneficiaries chosen, the number of borrowers of higher quality would also be greater. This would be especially relevant when a purposive choice of borrowers is made by financial intermediaries with or without the assistance of the government. Further, by encouraging a degree of disintermediation, lower interest rates increases equity relative to debt, which is always better from the point of view of high quality borrowers, since it reduces the possibility of bankruptcy when profits are not high enough to meet debt obligations.

5. Financial liberalisation

The natural outgrowth of the financial repression-based critique of intervention in financial markets is financial liberalisation. Financial liberalisation as the term obviously suggests is a process of diluting or dismantling regulatory control over the institutional structures, instruments and activities of agents in different segments of the financial sector. Inasmuch as these regulatory controls emphasise one or more objectives to be served by the financial sector, liberalisation most often implies a change in the role expected of the sector.

Deregulation in turn involves: (a) the removal of restrictions on domestic financial agents including in their access to capital from outside the domestic financial area; and (b) the removal of restrictions on the entry of foreign financial agents into the domestic financial area and the dilution of controls on their operations in the domestic market.
There are four aspects to the process of financial liberalisation. The first involves a substantial reduction of government intervention in setting interest rates and allocating credit. The second involves a change in the structure of the financial sector by easing entry conditions and increases the autonomy of financial agents when mobilizing resources and making investments in order to encourage competition. The third involves the creation of new structures of regulation that are less interventionist but hopefully would increase transparency in the operations and improve accounting practices of financial institutions and alleviate the effect that market imperfections have on the nature of transactions in and the competitive structure of the financial sector. And, finally, the fourth involves policies that increase the degree of financial openness, i.e. the ease with which residents can acquire assets and liabilities denominated in foreign currencies and non-residents can operate in national financial markets.

As early as 1985, Diaz-Alejandro had detailed how efforts in Latin America in the 1970s to follow the recommendations of the financial repression stand-point by “seeking to free domestic capital markets from usury laws and other alleged government-induced distortions” had not resulted in the outcomes predicted. Instead, they had “yielded by 1983 domestic financial sectors characterized by widespread bankruptcies, massive government interventions or nationalization of private institutions (to save financial firms and preempt adverse effects), and low domestic savings.”

There were a number of problems here. Because of the belief among depositors that the government would protect their deposits and because of the likely ripple effects of the closure of financial intermediaries would have on the rest of the financial system, it was expected and it did happen that the government would step in during times of crisis. This meant that there was no credible threat of bankruptcy, leading to typical moral hazard problems in the financial sector. In addition domestic depositors and foreign lenders came to believe that the state was offering them a sovereign guarantee, even if that was nowhere explicitly stated.

Secondly, the evidence suggests that liberalisation was not accompanied by the creation of an adequate supervisory and prudential regulation system worsening these problems substantially. Third, the result of these developments in imperfect markets was the strengthening of oligopolistic power through the association of financial intermediaries and non-financial corporations. Financial intermediaries that were a part of these conglomerates allocated credit in favour of companies belonging to the group, which by no means was a more efficient means of allocation than could have occurred under directed-credit policies of the government.\(^2\)

Fourth, financial liberalisation did not necessarily result in intermediation of financial assets with long-term maturities, with deposits and loans of less than six months’ duration dominating. And despite short booms in stock markets, there was little mobilization of new capital or capital for new ventures. In fact, small investors tend to withdraw from

\(^2\) In India, nationalisation of the bigger private commercial banks was partly motivated by the need to prevent the diversion of household savings to companies linked to the banks or their directors.
markets because of allegations of manipulation and fraud, and erstwhile areas of long-term investments supported by state intervention tended to disappear.

Fifth, while financial liberalization did encourage new kinds of financial savings, total domestic savings did not increase in many cases, and expansion of available financial savings was the result of inflow of foreign capital. Investment performance too did not reflect signs of either improved volume or more efficient allocation. Sixth, the Southern Cone experience of the late 1970s and early 1980s suggest deregulation in those countries did not lead to stable interest rates, that interest rates on the whole remained very high and way above “reasonable estimates of the socially optimal shadow real interest rate.”

Finally, the “combination of free capital movements, and domestic and external financial systems characterized by the moral hazard and other imperfections … set the stage not only for significant misallocation of credit, but also for macroeconomic instability”. (Diaz-Alejandro)

Despite this background all the countries covered in the Macroeconomics of Poverty Reduction programme in Asia have either been required as part of Bank-Fund conditionality or have voluntarily chosen to adopt policies of financial liberalisation to differing degrees. These have involved changes in policies with regard to foreign capital flows into domestic markets, and (sometimes as a consequence) changes in rules and regulations governing domestic firms and institutions.

5.1 The Experience with Financial Liberalisation in the Mixed Economies in Asia

The case studies relating to the mixed economies in Asia (Nepal, Bangladesh and Indonesia) indicate that: (i) independent of the size and economic status of a country the liberalisation of the 1990s involved a substantial degree of financial liberalisation; (ii) that liberalisation, while it did appear to have resulted in financial deepening, was accompanied by the loss of even the limited access to savings and credit available to sectors like agriculture and small scale industry, whose development had a crucial role in the poverty-reduction effort; and (iii) in all cases the process of liberalisation does seem to have increased financial fragility and in some, such as Indonesia, resulted in a financial crisis that worsened the poverty situation.

Moreover, financial liberalisation inevitably occurred in a context in which there was a shift in emphasis in macroeconomic management from fiscal to monetary policy. This required greater central bank independence from the government, ensured by curtailing or doing away with government access to central bank credit. Further, monetary policy inevitably focused on inflation targets, resulting in tight money conditions, which were also favoured because the resulting higher interest rates helped attract foreign capital inflows in the more liberalised environment. All of these implied a deflationary stance that was aggravated most often by the process of financial liberalisation. The deceleration in growth that this led to was obviously inimical to the poverty reduction effort.

Nepal
Nepal’s process of financial liberalisation, which began in the mid-1980s, did result in a substantial degree of financial deepening with a proliferation of institutions and instruments. When the process started, there were two state-owned banks, two development banks (the Agricultural Development Bank of Nepal (ADBN) and the Nepal Industrial Development Corporation (NIDC)) and no non-bank financial institutions. The amendment of Commercial Bank Act in 1984 opened the door for new commercial banks to be established in the private sector. To start with, three joint venture commercial banks came into existence between 1984 and 1986. Since these banks mobilized capital through public issue of shares, activity in Nepal’s stock market and the extent of public participation increased. Subsequently, a number of new commercial banks were established in the private sector starting in 1990, taking the number to the figure of 16 commercial banks that are now in operation. Thus, competition and customer choice in the banking sector was increased as a result of the liberalisation.

Further, the Finance Company Act of 1985 saw the creation of a number of finance companies. By March 2002 there were 53 such finance companies, besides 16 development banks, 13 insurance companies, 34 credit co-operatives and 25 institutions established by NGOs to offer limited banking services. Overall, more than 160 financial institutions have been established in the last decade. This diversity of institutions resulting from the reduction of entry barriers should in normal circumstances have substantially increased the ability of the system to mobilise financial savings and permitted the widening access to the formal financial sector geographically and in terms of customer profile.

The evidence points to an eight-fold increase in deposit mobilisation by the banking sector during the 1990s (from Rs 22 billion in 1990 to Rs 181 billion in July 2001). Deposit mobilisation by the finance companies also increased substantially. As a ratio to GDP, bank deposits increased from 19 per cent in 1985 to 43 percent in 2001. Deposits with non-bank financial institutions also increased from 0.5 per cent of GDP in 1995 to 4.6 per cent in 2001. The consequent financial deepening is reflected in the fact that the ratio of financial assets to GDP rose from 29.3 per cent in 1985 to 32.5 per cent in 1990 and a huge 84.3 per cent in 2001.

This obviously increased credit provided by the financial system substantially. Commercial banks' credit to the private sector has risen from 8.7 percent of GDP in 1985 to 29.4 percent in 2001. But it did not imply a similar increase in overall credit provision, but rather also reflects the transfer of credit provided by the informal to the formal sector, implying some degree of consolidation of the credit system.

The problem is that such consolidation was not accompanied by increased credit to the poverty-sensitive sectors. Of the credit provided by the commercial banks in 2001, only 9 per cent went to the agricultural sector whose importance from the point of view of livelihoods and poverty reduction in Nepal had been noted earlier. On the other hand, credit to industry increased from 18.8 per cent in 1985 to 45 per cent in 2001. Although a part of this increase reflects a shift from the commercial sector, whose share fell from 44 to 33 per cent over the same years, a shift away from agriculture is also likely. Further
small borrowers must have been discriminated against since 85 per cent of formal sector lending is based on collateral. The evidence indicates that despite financial consolidation, not more than a fifth of borrowing households in Nepal are covered by institutional finance.

This trend is not surprising given the fact that liberalisation has seen the rise to dominance of the private financial sector. The ratio of private sector credit to total credit rose from 68.5 per cent in 1985 to 76.2 per cent in 1990 and an overwhelming 92.5 per cent in 2001. Further, evidence on interest rates also suggests that smaller and less risky projects offering lower private returns may have been squeezed out of the market. Encouraged by the deregulation of interest rates associated with liberalisation, interest rate spreads in the banking sector touched 7 percentage points, and was brought down to 5 percentage points through the intervention of the Nepal Rastra Bank.

Liberalisation and the attendant consolidation of financial activity within the formal sector have also increased the urban bias of the financial sector in terms of access. Formal banking institutions are located in the urban and suburban areas, the directives of the central bank to expand services in the rural areas and lend to the priority sectors have not been complied with, and government-owned or controlled banks that had an extensive network in the rural areas have not just stopped opening new branches there, but are closing, amalgamating or transferring the existing branches to more accessible areas for reasons of security and profitability.

In particular, banks set up as joint-ventures with foreign participation have avoided opening branches in rural areas and have systematically flouted the central bank directive that requires banks to set up two branch offices (later reduced to one) in the rural areas for every one in the urban areas. On the other hand these banks, particularly the older and bigger among them, have over a relatively short period cumulatively paid out dividends that are many multiples of their initial equity investment.

Liberalisation has involved a change in the government’s priorities as well. The priority sector credit program, which required all commercial banks to direct 10 per cent of their loans to sectors such as agriculture, rural and urban small industries and basic services is reportedly being phased-out soon.

The net result has been a reverse flow of financial resources from rural to urban areas. Rural credit-deposit ratios are low implying that deposits mobilised in rural areas by the state-controlled commercial banks are used to finance business and industry in the urban areas. On the other hand, the Agricultural Development Bank, which was expected to mobilize deposits in the urban areas to extend credit in the rural areas, has failed to do so because of its own inclination to finance urban businesses.

These trends are disturbing given the crucial role of credit in sustaining investment by poor rural households. A mid-1990s survey (NRB 1994) established that only 20 per cent of rural borrowers have access to the formal banking system, many of them supplement this credit with resources from the informal sector and 80 per cent rely purely on informal sources. A later survey (CBS, 1997) estimated that close to 60 per cent of households are
borrowing households, with figures standing at 35 percent in the urban areas and 66 percent in the rural areas. Moneylenders and relatives account for more than 80 percent of the borrowing whereas bank borrowing is just 16 percent of the total borrowings.

Collateral-based lending practices have kept small, marginal and land-less households out of the market for formal credit. Around 86 percent of formal sector credit is against collateral in the form of land or other property and only 12 percent of the borrowing takes place without any collateral. Since 49 percent of households possess less than 0.5 hectare of land, their assets are obviously not sufficient to obtain large loans. Further, the 1994 survey found that the distribution of formal sector credit remains highly unequal. Only 9 percent of landless households had access to such credit as compared with 38 percent in the case of households with large farms.

In sum, while financial liberalization has expanded the financial services network, led to financial deepening and enlarged the access of urban borrowers to institutional sources of credit, it has failed to increase the access of the majority of the poor in the rural areas to such credit. This has necessitated dependence on informal sources at exploitative terms (involving high interest, gifts and premiums, free labour and bonded labour), which sustains the cycle of indebtedness and poverty.

**Micro-Finance**

As in other situations of financial liberalisation, a solution to these problems is being found in an emphasis on micro-credit in rural areas. Unfortunately, the transaction costs associated with micro-finance ventures are extremely high, resulting in high interest rates. However, liberalisation implies that no subsidies and transfers from the state are now available to render micro financial services feasible as a source of capital for productive investment.

Micro-credit programmes in Nepal include the following: Small Farmers Development Programme (SFDP), Production Credit for Rural Women (PCRW), Micro Credit Project for Women (MCPW), Credit to the Deprived Sector, Rural Development Banks (RDBs) and credit operations of NGO’s engaged in providing banking services. Besides, the Intensive Banking Programme (IBP) also serves the small and marginal income households in its credit operations. There are also around 1600 cooperatives involved in rural financing. They are estimated to be mobilizing around Rs 15-20 billion a year, which is about 10 per cent of the commercial bank deposits (NRB, 2002).

There are a number of positive pro-poor characteristics associated with many of these programmes. They are targeted at specific sectors with a preponderance of the poor, they provide credit without collateral on the basis of a group guarantee, and they combine credit with other technical services. There are also a number of success stories, where the programmes have made a difference to the participation of the poor in economic activity. But in general these programmes are characterised by a number of weaknesses such as high costs of service delivery, high interest rate, low loan recovery and donor dependence. (NSAC, 1998).
These features of micro-finance raise a number of questions about its sustainability. Since it remains the principal way in which the adverse consequences of financial liberalisation for the poor are dealt with, there is little hope of the process yielding sustained pro-poor growth. While efforts to improve the system of micro-credit must continue, some return to intervention seems inevitable in predominantly rural developing economies with a high incidence of poverty.

**Bangladesh**

In Bangladesh too, the process of financial liberalisation that began in the early 1980s has resulted in the proliferation of financial institutions and increased activity in the stock market. Liberalised entry conditions in the banking sector have led to a situation where there are around 30 private banks operating along with the four nationalised commercial banks and competing for deposits. These private sector banks account for around 50 per cent of deposits in the banking system.

In the early 1990s, liberalisation involved the loosening of controls over interest rates. Initially, a floor was set for the deposit rate and lending rates were freed, except for lending to the priority sectors like agriculture, exports and the cottage industries, for which interest rate bands were specified. Lending to the priority sectors was subsidised by providing compensation to cover the difference between the specified rate and the market rate. Subsequently, the floor for the deposit rate and the subsidies on priority sector lending were withdrawn, and though there were ceilings on the lending rates for the priority sector, these were so high as to make little difference. In sum, liberalisation as elsewhere involved a retreat from a situation of directed credit at subsidised interest rates for specified sectors, which were crucial from the point of view of poverty alleviation.

As was to be expected, the shift has resulted in a substantial fall in lending to the priority sectors. While the nationalised commercial banks are restructuring by reducing the number of rural branches, the private sector has shown little inclination to lend to the priority sectors. The ratio of lending to agriculture to its contribution to GDP fell from 0.99 in financial year 1987 to 0.86 in 1990 and 0.67 in 1998. Similarly, lending to the small-scale sector as a ratio of its contribution to GDP fell from 1.00 in 1987 to 0.54 in 1990 and 0.39 in 1998. This must have resulted in greater dependence of these sectors on informal sources of credit, with the expected consequences such as high interest rates that discourage productive investment.

This tendency was defended on the grounds that it was the price to pay for creating a more flexible and efficient financial system. It was no doubt true that the nationalised commercial banks were characterised by high costs of financial intermediation and poor loan recovery rates. But while liberalisation did little to cure this, it generated new problems in the private commercial banking sector. In the latter, while lending was not determined by political influence, as in the public sector banks, weaknesses resulting from excessive lending to the units held by the controlling interests of private banks and/or their directors were visible. As a result defaults and non-performing loans increased, forcing the central bank to enforce some regulatory control over the behaviour of sponsor directors.
The private banks partly dealt with this problem by exploiting the liberal interest rate regime and maintaining a high spread between deposit and lending rates, which touched as much as 7 per cent. That is, liberalisation that was expected to encourage competition, improve efficiency and reduce spreads, actually resulted in an increase in spreads. Since the financial system was imperfect, the more efficient banks reaped relatively high profits as a result. In fact, Hassan (1996) has found that lending rates tend to be rigid and are not really affected by the central bank’s effort to enhance liquidity in the system. Interest rates seemed to be more responsive to the rate of inflation, pointing to the stickiness of real rates of interest. Overall, the prevalence of high interest rates, because of imperfections in the market for finance, had a dampening effect on investment and also worsened the budgetary position of the government by increasing its interest burden.

Bangladesh was a leader in attempting to use micro-credit as a solution to the credit access problem (for the poor) created by financial liberalisation, with the Grameen Bank becoming a model of sorts for this experiment elsewhere in the developing world. There has been a virtual explosion of micro-credit programmes in the 1990s, implemented under various institutional arrangements run by NGOs as well as (increasingly) by government organizations. The average annual disbursement of loans from these programmes is estimated to be over Taka 5000 crores (US$ 0.9 billion), far exceeding the scale of total rural operations of the nationalised banks and specialised banking institutions taken together. Impressed by the growth of the movement the government has even attempted to centralise flows of micro-credit through a public sector organisation created for the purpose called Palli Karma Sahayak Foundation (PKSF). The share of PKSF in the loanable funds available with the micro-finance institutions has increased from 9 per cent in 1996 to 24 per cent in 1999.

However, with hindsight it appears that, despite successes, the problems typical of the micro-finance sector plague this country as well. Besides the differences that exist with regard to the extent of coverage of the rural poor and the contribution of micro-credit to pulling its clients out of poverty, the common problems noted are: (i) excessively high rates of interest; (ii) inability to reach in a financially viable way the really poor; (iii) donor dependence; (iv) high rates of default; and (v) financial unsustainability. Micro-finance, the Bangladesh experience too suggests, has yet to deliver on it promise and is no alternative to a regulated financial system required to play a developmental and poverty reduction role as well.

Besides these problems with regard to the role that the financial system needs to play with regard to development and poverty alleviation, Bangladesh’s experience with liberalisation also reveals the dangers associated with the lax monitoring of the financial sector that tends to be associated with financial liberalisation. In 1996, when foreign portfolio capital had begun to flow into the stock market as a result of revised rules in this regard, Bangladesh’s still immature stock market went through a boom-bust cycle that has become typical in many developing countries that have adopted financial liberalisation. The stock price index rose three-fold in a short period of 2-3 months, driven by the buoyancy generated by a small flow of portfolio capital into a market.
lacking width and depth, only to collapse thereafter. While the bubble was created by speculators in an immature and poorly regulated market, the real losers were middle class investors who had been attracted by the high returns that market instruments seemed to offer.

**Indonesia**

The dangers of financial liberalisation with an emphasis on greater flexibility for private capital come through in the case of Indonesia, the third and largest of the market-driven economies covered by the case studies. An analysis of the factors that resulted in Indonesia succumbing to the East Asian crisis in 1997 points to the important role that the country’s large external debt played in this regard. Indonesia’s debt, at 65 per cent of GDP in 1997, was much higher than that of Malaysia, Philippines and Thailand, despite the fact that its “need” for external resources as defined by the investment-savings gap was much less. One consequence was that in the pre-crisis year of 1996, 43 per cent of its merchandise export earnings were going to meet debt payments compared to around 25 per cent for the Philippines, 17 per cent for Thailand and 10 per cent for Malaysia.

The roots of the process that led up to the above situation can be traced to policies of financial liberalisation. Interestingly, while Indonesia had put restrictions on borrowing by domestic banks from international banks, it had completely freed borrowing by domestic corporates from the international financial system. The result was a sharp build up in private, non-guaranteed, short-term debt. Such debt amounted to close to double its reserves in 1997.

Just prior to the crisis, in March 1997, 45 per cent of Indonesia’s debt was owed by corporations, and such debt amounted to 24 per cent of its GNP and more than three times its international reserves. As compared with this, Indonesian banks owed only 8.5 per cent of the external debt in 1996-1997.

When the contagion effects of the Baht devaluation began in July 1997, this high share of short term debt both provided the grounds for banks refusing to turn-over such debt, and for speculators to launch an attack on the rupiah, expecting it to devalue. To boot, unlike many of the other Southeast Asian countries, the government in Indonesia did not make a strong effort to defend the currency by intervening in the market. With corporates and other agents with dollar commitments rushing in to buy dollars and cut their losses a spiral ensured, that led to massive capital outflows from the country. In 1997 alone this amounted to more than 10 per cent of GNP.

The collapse of the financial system and the liquidity crisis this created obviously set off a deflation that was aggravated by the contractionary policies, including cutbacks in state spending and high interest rates, that the IMF insisted upon as part of its bail-out effort. In the event growth slipped sharply and the poverty situation worsened as discussed earlier in this article. A country that was characterised by strong macroeconomic fundamentals, including a high rate of economic growth, a positive fiscal balance, low inflation and reasonable levels of international reserves, experienced a meltdown that hit its poor really hard.
One of the features of financial liberalisation in Indonesia as elsewhere was the easing of entry into and lax regulation of the banking sector. There were 240 banks in operation at the time of the crisis, making competition unhealthy and supervision difficult. Lending to the private sector financed with deposit liabilities rose sharply in the 1980s and 1990s, and credit was provided to linked or affiliated enterprises and influential individuals, with projects that were not always viable. When the crisis came and deflation ensued, banks found themselves saddled with non-performing loans amounting to 60 per cent of their portfolio. Thus, though the crisis itself was not a creation of the banking sector, but of errant corporates, the banks were hit severely.

In the run on banks that ensued, the Bank of Indonesia had no other option but step in to protect depositors and the banks and prevent a collapse of the financial system. It provided 144,536 billion rupiahs (around US$13-$16 billion, depending on the exchange rate used) of liquidity credits or assistance (called BLBI) to domestic banks between November 1997 and January 1999. Further, when it proved impossible to keep a bank afloat with assistance, the government virtually resorted to backdoor nationalisation. The Indonesian case study reports that: “In September 1998, the Government closed banks with a capital adequacy ratio (CAR) of less than -25 per cent and started a recapitalization process for banks with a CAR of between -25 per cent and 4 per cent. Those with a CAR of 4 per cent or above were allowed to operate normally, with the stipulation that this ratio be increased to 8 per cent over two years. In 1998-1999, around 100 banks were closed. Those that met the 4 per cent CAR minimum in mid-1999 accounted for only 5 per cent of total bank deposits (Radelet (1999)).” The result was that the Government took over many of the failed banks and their assets. As Diaz-Alejandro had noted in the Latin American case, the theory underlying financial liberalisation notwithstanding, there is no credible threat of bankruptcy that can be enforced.

According to an audit by Indonesia’s Supreme Audit Agency (BPK) in 2000, the government lost as much as 96 per cent of the liquidity credits (138.6 trillion rupiahs) issued and that around 84.8 trillion rupiahs (59 per cent) had been misallocated and misused. The liquidity assistance funds—which were intended to keep the banks liquid and able to handle massive withdrawals—were used to speculate on the dollar or pay bank obligations.

To finance the recapitalization process in private banks the Government had provided as much as 80 per cent of the funds required to ensure a capital adequacy ratio of 4 per cent, with the promoters of the banks themselves bank providing the remaining 20 per cent. The banks were also allowed to swap their non-performing loans for recapitalisation bonds in order to clean up and strengthen their asset positions. Further, the government had also provided Rp 267 trillion to Bank Indonesia (BI) to fund the government guarantee scheme for bank liabilities. All in all, the effort at salvaging the financial system had increased government debt by Rp 703 trillion. There was a sharp shift in 1999-2000 in bank assets from claims on the private sector (or bank loans to the private sector) to claims on the Government.
sector) to government bonds (claims on government, i.e., the recap bonds). Bank loans comprised only 30.6 per cent of bank assets at the end of 2001, while recap bonds made up 43.2 per cent. Bank loans used to make up 70 per cent to more than 80 per cent of bank assets during the pre-crisis period. Clearly the losses of the banking system that resulted from the sequence of events set afoot by liberalisation had been “socialised”.

Bank Indonesia estimates that the use of recap bonds and bonds for guaranteeing bank liabilities has resulted in a doubling of government debt between 1998 and 2000. By the end of 2001, the domestic debt was 46.2 per cent of total public debt. Interest payments on domestic debt shot up from zero in 1997 to 12 per cent of government revenue and 2 per cent of GDP in 1999 and to 22 per cent of government revenue and 4.4 per cent of GDP in 2001, with the absolute amount almost tripling. Further, principal obligations due from the recap bonds are expected to surpass Rp10 trillion in 2003, Rp 40 trillion in 2004, Rp 60 trillion in 2007, Rp 90 trillion in 2008 and Rp 100 trillion in 2009, if nothing is done to prematurely retire these bonds or change their structure and terms. The demand that the process of dealing with the financial crisis has placed on the government’s resources is indeed immense.

The Indonesian experience starkly illustrates why the imperfect nature of financial markets necessitates regulation and substantial caution with regard to financial liberalisation. Not only is the possibility of crisis great when regulation of the financial system is relaxed, but when the crisis does occur the state is forced to step in, despite the “let markets rule” principle that underlies the framework. The consequences of such inevitable action are regressive, with the people at large having to bear the burden through the diversion of a large share of government resources to redressing the adverse effects resulting from the profligacy, speculation and malpractices indulged in by a few.

5.3 The Experience with Financial Liberalisation of the Countries in Transition

Having started with highly regulated financial sectors with a fairly limited intermediation role, the experience with financial reform and its impact in the countries in transition has been different and varied. In Mongolia, for example, the extent of development of the financial sector was limited at the start of the transition. It was not that the financial system did not exist, but it functioned poorly. The functioning of banks - state owned and private – had been affected by the absence of a well-designed system of bank regulation. They were characterised by lending policies that involved the favoured treatment of a few customers, a poor track record with regard to repayments and defaults, and had accumulated a large volume of bad debts. In effect, the financial system was a poor allocator of investment funds and was in a state of collapse necessitating its restructuring. According to one estimate, the restructuring of banks in 1996 had cost close to 10 per cent of GDP.

In addition, the financial structure in Mongolia, with a strong urban bias was not suited to the economic structure that the transition had resulted in. Griffin observes that the poor in Mongolia are difficult to reach, because they are scattered, isolated and highly mobile. Thus, the task of raising the rate of investment there must be based on mobilising local
communities to identify priorities, search for solutions and contribute resources to finance small-scale local projects.

Dependence on foreign aid has resulted in an appreciation of the country’s currency, making aid a substitute for local industry that can compete in the domestic market against imports and in export markets in neighbouring countries. Thus, reduction of dependence on foreign aid is crucial for any process of pro-poor development. But greater self-reliance requires mobilising the small surpluses available with a scattered population. This requires a financial structure that is dispersed, small in unit scale and yet viable – a structure that is difficult to create.

The banking sector in Mongolia was ill suited to these tasks. Crucial sections such as women, the herders and the poor in general, who constitute more than half the population, and may be willing to undertake productive investments and meet interest costs, do not have access to the banking system. Even small and medium enterprises in urban areas were starved of credit, because the banks preferred to lend to large units. The difficulty is that markets and market institutions do not arise automatically and there may be many markets, especially financial markets crucial to structural change, that may be “missing”. Thus state intervention to create financial institutions to undertake such tasks was a crying need in Mongolia.

It was not just that access to the formal financial system was most of the time limited to a few. Monetary policies adopted during the transition and the poor performance of the formal banking system have raised the cost of credit to levels that render most projects unviable. In the initial stages of the transition, when inflation was running high, real rates of interest were negative. But soon a restrictive monetary policy was adopted as part of the “shock therapy” strategy of transition, which removed all controls on prices and sought to hold down inflation with monetary levers. As a result real interest rates soared, dampening investment in a country where growth was crucial to poverty reduction. In addition, spreads between deposit and lending rates were unusually large, standing at more than 25 per cent in many cases, indicating an absence of regulation in the financial sector. It appears that a restrictive monetary policy was being used as a substitute for appropriate banking sector reform and capital controls to prevent capital flight.

As noted earlier besides reform of the banking system, what was required in Mongolia was a financial structure suited to cater to a population dispersed in remote areas. The aim of reform is partly one of creating a financial structure appropriate to its level of development and its objectives. This obviously requires a very different financial structure in which the role of institutions such as self-help groups organised into micro-finance ventures can be quite crucial.

The government in Mongolia has proceeded along both these lines. The Mongolian parliament passed a comprehensive Employment Promotion Law in April 2001, with the objective of creating a range of employment opportunities. The law enjoins the government to support self-employed workers and people engaged in partnerships or organised in cooperatives and ensure credit to small enterprises and family businesses.
This would require encouraging non-banking financial institutions and credit and savings cooperatives that can lend to SMEs and micro-enterprises. It would also require ensuring that commercial banks lend more and provide larger loans to SMEs.

Inadequate access to capital is a major problem facing small investors, the poor and the vulnerable. Routinely, micro-enterprises and SMEs report lack of access to credit as being among the principal problems they face. The evidence suggests that there is no lack of viable investment projects being pursued by people with the requisite technical knowledge and experience in the rural soums, aimags or Mongolia. They are however constrained by inadequate capital.

In part the Local Development Fund (LDF) was created in Mongolia to provide small income generation loans to the poor under the National Poverty Alleviation Programme (NPAP). But the reach of this programme is limited. Independent studies estimate that the programme serves only eight per cent of poor households. But being the principal micro-finance institution catering to the urban and rural informal sectors, the scheme does have promise.

The emphasis on micro-finance is reflected in the fact that in 1998, micro-finance institutions under the UNDP’s Microstart programme were given the status of Non-Banking Financial Institutions by the Central Bank of Mongolia. Even though the typical problems of poor loan recovery, high transaction costs and inadequate reach afflict micro-credit institutions in Mongolia as well, there are some successful experiments underway. XAS, a non-banking financial institution created under the Microstart programme claims that repayment rates have been more than 98 per cent, despite their high monthly interest rate of five per cent. Further, they claim that nearly 35 per cent of their clients are engaged in production (as compared to trading) and involved in areas such as furniture making, leather garments, boot making, and clothing manufacture. However, the majority of their borrowers clients are still engaged in trade and services.

Credit Mongol and Goviin Ehlel, which are non-banking financial institutions operating in aimag centres and rural soums, are also quoted as success stories. They have reportedly made loans to SMEs engaged in meat-processing, poultry, animal skin-products and cashmere products. Here too, the repayment rate is claimed to be higher than 90 per cent. Thus while the transition in Mongolia has not helped to successfully restructure the formal banking system in directions that are suited to pro-poor growth, there are signs of structural changes in the financial sector that are positive from the point of view of poverty alleviation, as well are in keeping with the requirements of a country with special characteristics.

However, there are many more areas in which financial growth needs to occur. One such is insurance. The transition to a market economy has been accompanied not only by a lower average level of income, but also by greater variability of incomes. This variability implies greater economic insecurity, especially since the guarantees of employment, basic needs and a range of social services offered by the earlier socialist system no more hold. Households are forced to manage the increased risk through uncertain means such as
diversifying sources of income within the household, acquiring assets that can be liquidated during periods of crisis, strengthening kinship ties and borrowing from informal sources in emergencies in the hope that it will be possible to repay the loan when conditions improve.

Such strategies arise because of the lack of the appropriate institutions to deal with risk, and they may not be the best means to do so. As the Mongolian case study states: “Almost always these informal arrangements are inferior to the formal institutions they attempt to replace. Privatization of risk management seldom works well, particularly for low income groups in low income countries.” Though some efforts are underway to introduce operate an unemployment insurance scheme, much more needs to be done in the area given the extreme variability of incomes and the attendant insecurity in Mongolia.

Cambodia

Cambodia too is a country where the transition has involved a process of reconstructing the financial sector. During the Pol Pot regime (1975-79), money and banking were abolished and the National Bank of Cambodia (NBC) physically destroyed. Immediately thereafter, transactions in Cambodia took the form of barter or were denominated and conducted with Vietnamese dong and gold. It was only when the People’s National Bank of Cambodia was established in 1980 that the riel was reissued and the reconstruction of the monetary system began and confidence in the national currency was slowly rebuilt. However, as the foreign presence in Cambodia increased with the return of peace, and especially after a the transition towards a market-friendly economy resulted in an increase in foreign investment in the 1990s, the flow of the Thai Baht and US dollar into the country increase. The presence of the US dollar was substantial because of the operations of the United Nations Transitional Authority in Cambodia with its large budget. Though the riel is used by the government to pay its salaries, it is largely used only for small transactions. During 1999-2001 domestic currency in circulation accounted for 80 per cent of that issued. Yet, the evidence suggests that the dollar remains the principal currency of use within the country. Both residents and non-residents use it, and its use is not restricted to foreign firms and the donor community and those dependent on them. Wages in many local firms too are paid in dollars.

The dollar is dominant not just in terms of circulation. Bank deposits are increasingly dollar deposits. The ratio of the value (in riel) of dollar to local currency deposits jumped from less than 1 per cent during 1990-91, to 26 per cent in 1992 and since increased continuously to touch 70 per cent. Many banks do not accept riel deposits. According to the Cambodian case study: “Out of 18 banks currently in the system (14 commercial banks and 4 specialized banks), only 8 are prepared to open deposit accounts in riel and only 5 offer fixed 12-month deposit accounts. All provide US dollar deposit accounts, while only 2 of the 18 accept deposits in foreign currency other than US dollar. Regarding lending operations, only 5 banks issue riel-denominated loans, and 3 of these are specialized banks. Among the 18 banks, 3 banks extend foreign currency loans other than in US dollars. Foreign currency deposits constitute a significant share of officially recorded broad money, reaching over 60 per cent during the last six years, except for the
crisis period in 1998 when their share fall to 54 per cent. Since the mid-1990s the foreign currency share, especially the US dollar, represents about 95 per cent of commercial bank deposits, and 98 per cent of loan portfolios.” Though there is no official policy of dollarisation Cambodia is substantially a dollarised economy.

The political and socio-economic instability that resulted from internal strife, the high rates of inflation in the early years of the peace and the disarticulation created by the dollarisation that resulted from aid-dependence have all resulted in a malformed financial sector in which there was little confidence and a cash-driven economy. The financial sector was characterised by an extremely low level of intermediation with commercial banks assets amounting to just 18 per cent of GDP. The banking sector itself was small and relatively concentrated. At the end of June 2002 the top 5 commercial banks in Cambodia accounted for 70 per cent of assets, 80 per cent of deposits and 70 per cent of credit delivery. These banks attracted deposits and provided credit amounting to 9.6 per cent and 6.1 per cent of GDP respectively. The excess liquidity with the banking system suggested by these figures is corroborated by the fact that the reserves of the banking system, consisting of cash and deposits with the National Bank of Cambodia amounted to 29 per cent of its assets. The operations of the banks were also geographically limited, since they were present in only a few centres and were patronised by a small proportion of the population. The high costs that all this implied resulted in spreads between deposit and lending rates of 12-15 per cent, making bank credit a poor support for productive investment especially by the poor. Further, these features explained the cash dependence of the economy noted earlier.

Given these features of the “formal” financial sector in Cambodia, it should be obvious that the role of reform has been to re-establish the sector on a firm footing and building confidence in the financial system. We must recall that through the 1980s the People’s National Bank of Cambodia (PNBC) functioned as a monobank. It was only when financial liberalisation was adopted as part of the reform starting 1989-92 that a banking ‘system’ emerged. In 1991 the PNBC and the National Treasury were separated, and two commercial joint ventures between PNBC and private banks were established. This was followed in 1992 by the renaming of the PNBC as the National Bank of Cambodia, its conversion into a central bank divested of commercial banking functions, and the establishment of eight additional commercial banks, some of which were locally incorporated and others were subsidiaries or branches of foreign banks.

In 1994, a policy framework paper prepared as part of support to be extended under the IMF’s Enhanced Structural Adjustment Facility identified the tasks in the banking sector as follows:

1) Reducing or eliminating where possible the direct intervention of the government with the aim of strengthening the role of market forces in the allocation of financial resources;
2) Developing a modern banking system and promoting competition among commercial banks;
3) Enhancing the effectiveness of monetary policy instruments; and
4) Strengthening the legal and regulatory framework in order to ensure an effective and smooth conduct of central and commercial banking activities.

Subsequently, a series of laws were enacted to put in place a system of supervision and prudential regulation of the banking system. The 1999 Financial Institutions Law implied extensive restructuring with minimum capital requirements being specified for different kinds of institutions. A process of relicensing adopted in 2000 resulted in a system of 31 banks, including 22 private commercial banks, 7 foreign bank branches, and 2 state-owned banks, being cut down to a total of 12. As a result of subsequent restructuring there were 18 banks in operation in 2002, most of which have met their minimum capital requirements. Banking reform has also involved the complete liberalisation of interest rates. Further, with the National Bank of Cambodia not undertaking refinancing operations, it has little influence on the interest rates.

However, the process of reconstruction of the banking system is still seen as incomplete. The country study on Cambodia argues: “Various institutional factors continue to hinder development of the banking sector. These include: (i) high information cost, (ii) the lack of legal infrastructure to support the enforceability of financial contracts, and (iii) a weak bank supervisory and regulatory framework. All these factors together lead to high risk and a high cost structure for the banking system, resulting in credit rationing and inefficient financial intermediation. Banks are very cautious about providing loans because of a lack enforceable collateral and limited investment projects, and often prefer placing funds at the NBC. As the result the loan to deposit ratio is low (68 percent). While this cautious portfolio management helps to secure a stable source of income, expected returns remain low, and banks have little incentive to mobilize savings. Furthermore, the public itself still does not fully trust the banking system, and people often prefer holding gold or cash to opening deposit accounts at banks.”

The disturbing feature is the relatively unregulated presence that banks have in the international market. Being substantially dollarised and flush with dollar liquidity, banks reportedly hold a substantial share of their deposits in foreign exchange accounts abroad. This is partially reflected in “other capital” outflows in the balance of payments. There is uncertainty about the quality of these assets, especially because many banks have significant non-performing loans in their home country. What is not too clear is the effect of a regulation implemented in October 1998 preventing the transfer of domestically collected funds abroad, which has reportedly increased the excess reserve ratio (excess reserves divided by total deposits) significantly to around 50 per cent, because of the lack of a central bank liquidity facility or an inter-bank market.

Even without this external factor, the system is known to be burdened with a high ratio of non-performing to total loans (about 20 per cent at end-December 2000), even with a rather generous definition of non-performing loans.3 Although these loans are provisioned for

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3 The classification of overdue loans is as follows: ‘standard’, 3 < 6 months; ‘doubtful’, 6 < 12 months; and ‘lost’, >12 months.
they squeeze profitability and keep interest rate spreads extremely high at around 15 percentage points.

Given all of this the role of the banking system in development has been limited or absent. As we had noted earlier given the structure of the Cambodian economy and the proximate determinants of poverty, rural employment in agriculture and non-farm activities is crucial for poverty alleviation. This requires a financial system that is able to provide credit to farmers and rural enterprises, especially small farmers and entrepreneurs.

However, the banking system is singularly incapable of performing this role, and the nature of the financial reconstruction process is not such that it can result in the emergence of such a system. More than half of the rural population of 9.6 million is not even serviced by the formal financial system. There are very few bank branches outside Phnom Penh, and that too of the RDB (state-owned), ACLEDA Bank, Specialized Peng Heng SME Bank and the Cambodia Agriculture and Industrial Specialized Bank in towns like Battambang, Sihanoukville, Siem Reap, Kampong Cham, Pailin, Kandal and Koh Kong. Sixteen provinces accounting for close to half the population have no bank branches at all. And where they do exist, they cover a large population and are concentrated in provincial capitals.

And even for those with physical access, credit is virtually unavailable. A mere 6 per cent of bank advances are provided for agriculture or related activities and these are in the nature of short-term dollar denominated loans that are unlikely to be used for long term investments. This compares with the fact that under the mono-bank system that prevailed before reform the NBC through it provincial branches provided small loans to thousands of farmers based on mutual guarantees.

The NBC estimates that the demand for rural credit is in the range of $120-130 million a year, and a third of this is for small loans of around $50-300 per borrower. With the banking sector unlikely to provide such loans, the burden of development financing has fallen on specialised institutions like the Rural Development Bank and on micro-credit institutions. Even their reach is partial. There are reportedly about 90 NGOs supported by funding from domestic and international agencies providing micro-finance to nearly 420,000 poor households, or 15 percent of the total, with most of the borrowers being women.

But even this does not account for a major part of the borrowing. According to the CSES of 1996 (NIS 1997), approximately 813,148 rural households took loans with a total value of about KHR300 billion ($120 million) during 1994-1995. About 7 per cent of them obtained loans from traders, 15 per cent from moneylenders, 51 per cent from relatives, and 15 per cent from friends and neighbours. Of the remainder, 1 per cent took loans from banks, 10 per cent from NGOs and United Nations agencies and 1 per cent from others.
Thus, most of the rural poor have to fall back on informal sources, where interest rates vary from zero, on some loans from relatives and friends, to 20 per cent per month or more on those from traders and moneylenders. The average interest rates, including zero per cent loans, works out to 66 per cent a year. A significant proportion of these loans are used for consumption or emergencies such as illnesses.

However, some estimates suggest that even taking account of informal sources credit availability is way below the requirement. The unfilled gap for rural credit is estimated at anywhere between $45 million to $130 million (Bousso et al. 1997; Prins 1996; NIS 1997). Estimates of the current aggregate demand for rural credit is in the range of $75-125 million and current supply from all sources is of the order of $25-33 million, a credit gap of $50-100 million would appear to be a reasonable estimate.

Moreover, there is considerable scepticism with regard to the functioning and sustainability of the micro-finance sector. The NGO micro-finance institutions lack adequate resources, and often resort to bank loans, principally from the RDB. Even this source yielded only $500,000 per MFI because of the regulation limiting exposures to MFIs to 10 per cent of RDB’s net worth. Some institutions such as EMT and Hattha Kaksekar have borrowed from international markets, resulting in the risk of foreign exchange exposure, because foreign loans are in dollars whereas on-lending is in riels. In any case, risks are high with borrowing because MFIs borrow medium-term and engage in short-term lending. Further, many MFIs have borrowed to an extent that threatens their viability.

As noted earlier, banking for the poor is a high-risk activity given the vulnerability and high rates of mortality of units set up by such borrowers. In addition, MFIs are often not equipped enough to undertake proper risk-assessment and excessive caution can result in little lending activity. Even when land is used as collateral, Cambodia’s weak legal system still creates problems in loan recovery. Finally, high dependence on external funding raises the issue of sustainability, both because of the uncertainties associated with donor funding and because of the fact that cost issues are ignored by institutions used to receiving grants driven by social development objectives.

In sum, the transition in Cambodia has involved a shift to a liberalised financial system from a situation where the banking system had become virtually non-existent. Not surprisingly, the process has yet to create a financial structure suited to pro-poor growth. Rather, financial liberalisation is creating a formal institutional framework that is unlikely to contribute to the development and poverty alleviation effort. On the other hand specialised institutions and the micro-finance sector are unable to ensure anything like adequate lending and their sustainability is increasingly in question. Above all, the informal sector too is not delivering the resources required to cover the demand for credit. Hence, unless a major effort is made to expand, restructure and finance the financial sector, its role as an instrument for pro-poor growth is unlikely to be realised.

Vietnam
In Vietnam, the reform policy or *doi moi* adopted after the late 1980s did bring about a significant transformation in the operations of the financial sector. Though the process of dollarisation in Vietnam has proceeded to a lesser extent than in Cambodia, there are a large number of transactions that are denominated and undertaken in dollars and banks have been permitted to accept dollar deposits and undertake dollar lending. Further, financial liberalisation, as in other countries in transition, involved the liberalisation of interest rates on both foreign currency and *dong* deposits, greater emphasis on profitability in the state-owned and private commercial banking sector, a consequent reduction in the emphasis on directed lending with developmental objectives, and liberalisation of entry conditions into the financial sector, including foreign participation in the banking and non-banking financial sectors.

However, the liberalisation of interest rates on *dong* deposits in 1996 and dollar deposits in 1999 did not have the damaging effect of a sudden rise in rates because, despite interest rate ceilings, rates on *dong* deposits were quite high in the early 1990s, and well above the dollar interest rate. As a result rates remained stable. Moreover, even when deposit rates increased in 2001 and 2002, banks did not raise lending rates substantially but took a cut in margins, despite the need for loan loss provisioning. Thus, it appeared that the system was responding to the liberalisation not with price competition but by competing for volumes with regard to deposit mobilisation and loan disbursals. This experience goes contrary to what the financial repression literature suggests.

What liberalisation did do was to substantially increase monetisation and financial deepening in the economy, especially during the second half of the 1990s and thereafter. Money supply and domestic credit increased rapidly in the late 1980s, and the ratio of the M2 measure of money supply to GDP rose to 20 per cent, and then to levels higher than 50 per cent.

This process of monetary expansion was accounted for both by domestic and foreign currency movements. Domestic currency deposits as a percent of GDP grew from single digit levels in the 1980s and mid-1990s to 25.8 percent in 2001, while the ratio of domestic currency credit to GDP rose to thirty-five percent in 2000 and close to forty in 2001. Similarly, foreign currency deposits grew from less than one percent of GDP in 1986 to slightly over 18 per cent in 2001. Associated with the increase in domestic credit was an increase in net foreign assets with the banking system, which grew from less than ten percent of GDP through most of the 1990s to 24.3 percent in 2001. These increases in foreign currency deposits and assets are indicative of the acceleration in the process of dollarisation of the economy in the late 1990s.

The principal beneficiary of this process of financial expansion was the private sector. Credit to private sector rose from three percent of domestic credit in 1986 to more than one third of domestic credit in 1993, more than 50 per cent in 1999, and 60 per cent in 2002. Thus, the share of credit to state enterprises fell below half, indicating the shift in economic structure towards private production and distribution.
That shift in the structure of credit flow was partly the result of conscious action necessitated by the nature of the financial liberalisation programme. Prior to the reform, the government in Vietnam adopted a directed credit strategy, with emphasis on reaching credit to priority sectors. The emphasis was on ensuring finance for key projects in sectors such as infrastructure, public services, and basic and capital goods industries, almost all of which were state owned. There was also concern with reaching loans to the poor in urban and rural areas.

However, the liberalisation package favoured by the IMF and the World Bank not only required the privatisation of a large part of the public sector, but also the imposition of “hard budget constraints” on state-owned enterprises that were to be subjected to market discipline. While the government of Vietnam did not want to go along with these prescriptions in full, it did go part of the way. In the compromise, the policy of requiring the banks, especially the state-owned commercial banks, to engage in directed lending was diluted and they were expected to ‘go commercial’. The targets set in the credit programme explicitly stipulated that credit growth to SOEs should be restricted to slightly more than half of the programmed growth of domestic credit of the economy. The change in the structure of credit expansion partly reflects this policy shift, besides the rapid growth of the private sector after the reform.

On the other hand, the government won itself some space to continue with targeted lending through two routes. The first involved the creation in 2000 of a special Development Assistance Fund (DAF) separate from the commercial banking system, which would have as its objectives: (i) the provision of subsidised state loans for medium to long-term investments in priority sectors such as infrastructure, heavy industry and public services; (ii) provide interest-rate support and investment guarantees for chosen projects; and (iii) provide short-term export promotion credit. Support in these forms can go to both the private and the state-owned enterprises, taking account of both commercial and policy criteria, such as encouraging investment in underdeveloped areas, preferential sectors, and projects related to health, education, culture and sport. The DAF has branches in all sixty-one provinces, with a registered capital of five billion dong (US$326.8 million). Before 2002, the Office of the Prime Minister determined allocation of funds. Funds came from the Social Insurance Fund, the Sinking Fund, the Vietnam Postal Service Savings Company (VPSC), the government budget, loan repayments, and official development assistance (ODA). After 2002, DAF would have to mobilize its own resources. It could continue to draw funds from the sources mentioned above, through negotiation. If funds come from the government budget, this usually involves issuance of investment bonds.

Interestingly, outstanding credit from the DAF in 2001 to 2002, and loan disbursements in 2002 and 2003 grew much faster than total domestic credit to the economy. As a result disbursements through the DAF amounted to an increasing share of domestic credit, reaching 24 percent in 2002, equal to 3.3 percent of GDP. Currently, the DAF has

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4 VPSC was established in 1999. In 2002, it already had 539 to 600 branches all over the country, and has been a good and fast-growing venue to mobilize rural savings. There are around half a million deposit accounts with outstanding deposits at D3.8 billion (around $250,000).
emerged as the largest financial intermediary in Vietnam for channelling domestic and foreign funds to investment activities. The government plans to double its five trillion dong of capital to ten trillion ($653.6 million).

The second route through which the government expects to continue with directed lending is through the conversion of the state-owned Bank of the Poor into a Social Policy Bank (SPB) with a chartered capital of five trillion dong ($326.8 million) and branches in all provinces. All policy lending in the banking sector would be transferred to this bank. The new bank will provide micro-financing to agricultural households and low-income groups, mostly in the rural areas. The target borrowers are small rural households, micro-enterprises, and small and medium enterprises (SMEs). The SPB enjoys special privileges, including liquidity and solvency guarantees by the government, and is exempt from deposit insurance and tax regimes.

The importance of this is obvious. One study in Vietnam (CRP/ActionAid 2000), for example, found that although the access of the poor to credit improved because of projects such as the ‘Project on Providing Credit to the Poor’, under the ‘National Program on Poverty Reduction’, a considerable number of the poor, remained without access to credit. There is clear evidence of credit rationing to the disadvantage of households with limited land and a low level of educational (Do Qui Toan et al. 2001). It also appears that the majority of poor and very poor households in a rice growing area in the Mekong River Delta resorted to credit in informal markets, with high lending interest rates of five to thirty percent per month. In formal markets the typical rates were 1.2 to 1.5 percent (CRP/ActionAid 2000). The same study found that sixty-five percent of poor households interviewed put improved access to credit as their greatest need.

Because of their low cash incomes, many households used loans for purposes other than for which they formally contracted them, often consumption expenditures. As a result, access to future loans was reduced, reinforcing household poverty.

In sum, while the principal thrust of financial reform in Vietnam as elsewhere has been to render the system less regulated, more flexible and more ‘market-oriented’, with the attendant adverse consequences for pro-poor growth, there are a number of indications that the government has been able to partially neutralise the with alternative policies and structures. As a result the outcomes in the Vietnamese context are indeed different from that in Mongolia and Cambodia. This does have implications for policy in countries with little option but that of accepting the typical IMF-style financial liberalisation package, which we shall return to later.

**China**

Given its size, its long track record of egalitarian development and its post reform success, China is a case of a country in transition that has been able to manage the pace of its integration into the world system. In fact, China’s external liberalisation till now has been more cautious, though entry into the WTO may result in some acceleration in the process.
Though China is among the countries with substantial capital inflows, there are strict controls on access to external debt and on the inflows of portfolio investments. As a result inflows have mainly taken the form of foreign direct investment, which accounts for more than 70 per cent of the total since 1993. As Bouche et al. argue in their case study: “Chinese policy makers are well aware of the risks of instability, overheating and contagion associated with liberalizing the capital account in a context where reforms of the banking system and of the social security system are not fully fledged and have deliberately opted for a gradual path to full liberalization.”

China not only manages its exchange rate, which has been fixed at 8.3 yuan to the dollar since 1997, but also restricts access to foreign exchange. It has relatively stringent capital controls in place, though the government has in principle decided to move to full convertibility and a liberalised capital account.

Clearly, capital account liberalisation cannot be justified by the need for funds to finance investment projects, given China’s high savings, investment and growth rates at present. Thus, only arguments such as the need to increase competition in the financial sector and encourage financial deepening and diversification aimed at enhancing financial stability can be advanced in favour of the policy. But as discussed earlier, such arguments are not defensible either on theoretical grounds or on the basis of the experience with financial liberalisation in other developing countries. In fact, the East Asian financial crisis of 1997 indicates that even countries with strong macroeconomic fundamentals can fall victim of macroeconomic instability, because of imprudent lending by international financial institutions protected against default by an implicit sovereign guarantee and due to speculative borrowing by domestic agents aiming to exploit the liberalised financial environment to earn quick profits. Indeed China, along with India, is seen as having warded off the contagion effects of the East Asian financial crisis in 1997 because of its controls over capital flows. Given the observed effects of that crisis on poverty incidence in the East Asian countries, capital controls in China has to be seen as promoting pro-poor growth.

While the resistance, in practice, to capital account liberalisation has served the Chinese well, the government has chosen to reform its domestic financial sector as part of the move to a more market friendly environment. Such reforms, which increase the flexibility of financial institutions with regard to interest rates, lending practices and investment choices, are normally accompanied by policies seen as necessary to strengthen financial institutions and ensure adequate supervision and regulation. This move has gathered pace in recent years because China was under substantial pressure to undertake financial reform and permit a greater role for foreign financial institutions in its financial sector when it negotiated conditions for accession to the WTO. Many of those conditions have been accepted leading to a second wave of financial liberalisation.

These phases of liberalisation have seen the government introducing a series of long-term reforms in the financial sector, including those aimed at resolution of the non-performing loan problem and re-capitalization of the domestic banking system; reform of property rights within the banking system; interest rate liberalization and encouragement of entry of foreign financial institutions; establishment of core institutions and rules regarding
prudential oversight, transparency and disclosure; improving accounting standards; and protecting creditor and shareholder rights. Many of these are seen as prerequisites for relaxation of controls over short and long term financial flows as well.

In the years up to 1993, monetary policy in China involved the use of direct credit control in the form of mandatory credit quotas for the state-owned banks. Further, these banks were required to follow the central bank’s direction in the allocation of credit as well, which as was to be expected went primarily to the state sector. While this system worked during the years of price regulation, it did have inflationary consequences once price control was lifted.\(^5\)

Further, since bank lending was driven by policy criteria, rather than profit and risk principles, many of these loans were non-performing. State support to the banking system ensured that this did not matter. However, as more market-friendly principles came to govern both industrial and banking policy, these non-performing loans proved a threat to financial viability. Lardy (1998) estimates that the actual ratio of non-performing loans in the banking system in the 1990s was as high as 50 per cent. Other estimates (Xie, 2002) place the non-performing loan burden at 25 per cent of total loans in 2001, or 30 per cent of GDP.

After 1993, the objective of controlling inflation at less 3 per cent came to govern monetary policy. The central bank gave up its commercial banking operations as well as its concern with socio-economic programmes. Its interest now was to use instruments such as reserve ratios, interest rates and open market operations to control the rate of inflation. The consequent monetary stringency together with the unemployment associated with the restructuring of state-owned enterprises has periodically threatened China with deflationary and recessionary trends.

Further, in 1998, the use of a credit plan was dropped and credit provision came to depend on the demand for credit and the lending practices of the banks that were increasingly subject to market principles. Banks attempting to restructure and deal with their non-performing assets are in any case wary of lending to the private sector. In addition, deflation resulting from the factors described above would worsen the problem of credit shrinkage, since it would damage the capacity of enterprises to meet their repayment obligations and reduce the banks’ willingness to lend. This could result in a further contraction of economic activities. Thus a pro-poor strategy aimed at raising the rate of growth of output and employment must look to ways of reflating the system when required. Unfortunately, given the non-responsiveness of investment to interest rates, the role that monetary policy could play here was limited. Since money and capital markets remain underdeveloped, the financial sector continues to be the main source of intermediation in the economy as well as the main transmission channel for monetary policy. But neither was supply of credit from commercial banks easing because of the

\(^5\) Under the credit control regime, monetary policy followed a “stop and go” pattern, tightening when inflation was high and loosening when inflation was low, contributing to a cyclical pattern of growth and inflation. Periodically, to stimulate growth, the central bank would relax credit allocation restrictions, encouraging the state banks to lend to the expanding and profitable non-state sector. This in turn meant that the financing needs of the state sector had to be met by additional central bank lending (relending) and money creation, which stimulated inflation (Brandt and Zhu, 2001).
pains of restructuring, nor was the demand for credit rising rapidly because of the
deflationary tendencies.

Meanwhile, the banking sector was being transformed, with the separation of policy
lending from commercial lending. China’s formal financial sector is highly concentrated,
with the four state commercial banks accounting for around 60 per cent of total deposits
and loans, and the state owning and controlling 90 per cent of capital in the sector. The
Commercial Bank Law, of 1995, paved the way for the conversion of the specialized state
owned banks into commercial banks. The responsibility for policy lending to the state-
owned enterprises and for large development projects was restricted to just three policy
banks, viz., the State Development Bank, the Export Import Bank and the Agricultural
Development Bank (ADBC). In the urban areas, small and medium sized banks, such as
city commercial banks, were established with responsibilities for lending to small and
medium sized enterprises.

In the rural areas too the tasks of lending to farmers for agricultural production and off-
farm business, agricultural production organizations and TVEs was separated from
lending to state and collective agricultural enterprises, marketing cooperatives and multi-
township agricultural development projects. The former, which was within the frame of
policy lending was left to the rural credit cooperatives (RCCs) that were expected to
allocate more than 50 per cent of their loans to members. The latter was made the
responsibility of the Agricultural Bank of China (ABC). However, the separation of
policy lending from commercial lending was partial. Even the ABC, which was now to
focus on commercial lending, continued to engage in some policy lending for agriculture
and in the provision of loans for poverty relief. The ADBC, which was the policy bank
for agriculture was expected to manage the purchases of agricultural products.

Reforms relating to interest rates though present were more limited than in other such
contexts. While money market interest rates were deregulated in 1996, interest on
domestic deposits and loans continue to be regulated by the government. However,
interest rates on loans to SMEs by commercial banks were allowed to be 30 per cent
higher than base rates and by rural credit cooperatives up to 50 per cent higher. Further to
take account of risk in specific cases, financial institutions were permitted some
flexibility in setting lending interest rates. Interest rates charged by state commercial
banks were allowed to vary within a band with the ceiling and floor set at 20 per cent
above or below the administratively set rate. For other commercial banks and urban credit
cooperatives, the fluctuation range was set at 30 per cent and for rural credit cooperatives
at 50 per cent.

Finally, reforms were also aimed at encouraging sound financial practices. Measures
were undertaken to recapitalise the commercial banks and remove non-performing assets
from their accounts. For this, the government issued bonds valued at $32 million in 1998,
and four asset management companies were established to absorb non-performing loans
of around $170 million. Further, asset liability and risk management procedures were
introduced and the state owned commercial banks were required to reduce bad loans by 2
to 3 per cent annually. They were also issued guidelines to lend against collateral, take
account of borrower creditworthiness when lending and limit their exposure to any single borrower to 10 per cent of their capital.

To reduce risk and enhance financial stability the authorities chose to consolidate banks’ lending decisions at higher branch levels. Some rural and urban credit cooperatives were merged into banks. Restrictions were placed on the activities of non-bank financial institutions (NBFIs) such as rural credit cooperatives (RCCs), urban credit cooperatives (UCCs) as well as trust and investment companies (TICs), which had grown rapidly during the liberalisation since the early 1980s, such as. A few of them were merged or closed. Non-official financial institutions, such as rural credit foundations (RCFs) and illegal private banks were closed down or merged into the RCC system and creation of new units was prohibited. In the stock markets too transactions were subjected to tighter control during the late 1990s. In particular, the 26 regional stock exchange markets that were set up after 1993 were closed down and additional transactions made illegal.

While the concerns of the government were different, these monetary and financial reforms worked against a pro-poor growth strategy. In response to the inflation that peaked in 1994, the government tightened money supply by sharply reducing central bank lending to state owned banks. From about 17 per cent over the period 1986-1994, the growth rate of central bank lending to state owned banks fell to about 3.6 per cent over the period 1995-1999. In 1997 and 1998, it even declined in absolute terms. As a result, overall credit growth slumped from more than 20 per cent before 1995 to less than 10 per cent subsequently. While this helped curb inflation, it affected growth adversely. The rate of inflation fell for 3 consecutive years and the economy showed clear signs of deflationary tendencies by the beginning of 1998. This added to the unemployment resulting from the process of restructuring of state enterprises and the reforms necessitated by China’s desire for WTO membership.

Faced with deflation, the government did shift to an expansionary monetary stance in 1998. Reserve requirements for the financial institutions were reduced from 13 to 6 per cent over a period of about a year, the scope of their lending policies widened, and interest rates that had been cut twice in 1996 were reduced six more times thereafter making the rate on one-year loans in 1999 half that which prevailed in 1996. The interest rate for deposits too reached a quarter of their 1996 level. While this dampened the rate of increase in personal savings, the overall effect on consumer and investment demand was low.

The reasons were many. The overall inducement to invest did not rise and enterprise demand for credit was, therefore, not stimulated by the lower cost of credit. Further, state enterprises were faced with harder budget constraints in the wake of reform. And, finally, the unemployment risks associated with SOEs restructuring and WTO accession, and the rising costs of housing, education and health care, discouraged consumption spending and kept household savings at high levels. In the event, money supply growth at 14.8 per cent and 14.7 per cent respectively in 1998 and 1999 remained below the targeted 17 per cent. In fact, after a rise in 1999, the rate of growth of base money supply fell continuously to touch just 7 per cent in 2001.
These trends were aggravated by the reforms in the banking sector. Banks needing to address their ‘bad loans’ problems and faced with borrowers whose profits were being shaved because of recession, were less willing to lend. In the fourth quarter of 1999, the excess reserve ratio for state commercial banks stood at 8.6 per cent and for other commercial banks at 22 per cent. The aversion to risk this signified also implied that the banking sector was proving to be a poor channel for transmitting the effects of monetary policy. Fiscal policy adjustments were necessary to fight the deflation, as the Chinese government realised in the late 1990s.

It hardly bears stating that the risk-averse behaviour of the banks meant that the availability of credit to small and private firms, and to enterprises and households in rural areas, fell substantially. This was also because collateral and guarantee requirements had increased in the new context, which hurt many private firms, especially the SMEs. According to official statistics, the share of loans to SMEs by state commercial banks and joint stock banks rose significantly to account for around half of outstanding commercial bank loans. However, this was inadequate to meet the financing requirements of the sector. This forced those that remained in operation to rely on their own sources of finance. A 1999 survey of more than 600 private firms in Beijing, Chengdu, Shunde (Guangdong) conducted by the International Finance Corporation revealed that about 90 per cent of the start-up capital that went into these enterprises came from internal sources and that more than 62 per cent of investments in expansion were financed by the promoters or with retained earnings. Such reliance on self-financing or resort to informal sources of finance was found to be significantly higher among smaller firms than in larger ones.

Another survey conducted in 1999 on a sample of 1121 SMEs in Guangdong, Liaoning, Hubei and Yunnan revealed that 66.9 per cent of the enterprises that invested in fixed assets in 1998 did not obtain loans from financial institutions. More than 80 per cent of such investments were financed out of own funds in the case of 62 per cent of the enterprises. For those that did secure loan finance, the share provided by the state-owned banks was 52.5 per cent in the case of private enterprises as against 82.7 per cent for state-owned enterprises. The burden of reduced credit access was falling more on private SMEs. The bias against the private sector was also due to the fact that most bank managers expected to be bailed out by the government in the case of default on repayments by state-owned enterprises, as had happened in the past. Expectations were not the same with regard to loans provided to the non-state sector.

Reforms have also meant that local branch managers, faced with higher uncertainty with respect to capital availability have fewer incentives to identify good projects locally. This together with the shift of decision-making on lending to more centralized levels has contributed to the concentration of commercial bank lending in the cities, denuding the access to capital at and below the level of counties. Finally, the evidence suggests that the interest rate spread is still not large enough to accommodate the perceived risks in lending to private and SME projects. This despite the fact that controls on interest rates have been relaxed to some extent in recent years, and interest rates on loans to SMEs by
commercial banks are allowed to be 30 per cent higher than base rates and by rural credit cooperatives up to 50 per cent higher. The government did establish a network of 260 credit guarantee agencies in the late 1990s, in order to increase the access of SME’s to the formal banking sector. But, according to analysts less that one per cent of China’s SMEs qualify for support under the credit guarantee system.

In rural areas too financial reform has made a significant difference. The formal sector institutions charged with dealing with the rural areas - the Agricultural Bank of China, the Agricultural Development Bank of China and the RCCs - have been extremely successful in reaching out to, mobilizing savings from and channelising investment funds in the rural areas. In 1997, deposits in these institutions accounted for 27 per cent of total deposits nationwide. The RCC network alone increased its deposit mobilization by 7.7 times between 1990 and 2002 (June), while total loans increased 8.62 times over the same period.

However, once the ABC was made responsible for lending to state and collective agricultural enterprises, marketing cooperatives and multi-township agricultural development projects it was required to withdraw from rural townships and re-concentrate in county towns. This implied a substantial reduction in the number of rural finance outlets and adverse trends in the geographical distribution of rural finance. Between 1995 and 1998, the number of county-level branches of the ABC grew while the number of small and local branches fell significantly.

Further the closure of loss-making RCCs or their merger with better performing ones resulted in a reduction in the number of such cooperatives from 1995 to 2001. Unfortunately, a larger number of RCCs have been closed or merged in poor areas than in the more developed coastal areas, because they accounted for a majority of the loss-making units. In 1998, IFAD estimated that about half of RCCs in poor areas incurred financial losses, against one third nationwide.

As a result of these developments, the reforms may have significantly reduced the access of rural households, especially poor households, to formal finance. The problem has been amplified by RCC’s non-performing loan burden and risk aversion problems. RCCs also have become more cautious in their lending decisions and more demanding in terms of guarantees and collateral which, along with a limited scope for adjusting lending interest rates, contributed to excluding an increased number of low-income and poor borrowers. Until recently, the lending pattern of RCCs was strongly biased towards rural enterprises to the detriment of farmer households. In recent years however, due to the worsening performance of TVEs, as well as government efforts to involve RCCs in microfinance activities, this trend has somewhat reversed.

In China, the informal financial sector has played the most important role in supplying funds to farmer households. Over the period 1980-1996 informal lending grew at an average annual rate of 20 per cent. The measures adopted in the mid 1990s, including the disbanding of Rural Credit Foundations and the ban on money lenders and money shops, resulted in a fall in the growth of informal lending to only one per cent in 1997, In fact,
1998 saw an absolute decline. However, the bulk of farmers’ credit needs continues to be met by informal sources, suggesting that in its current design, the formal sector is not playing an adequate role.

Micro-finance schemes have also played a significant supplementary role in meeting the needs of low income and poor farmers. Microfinance activities started in the early 1990s as initiatives of international donors and NGOs to address some issues pertaining to the Subsidized Loan Program (SLP) implemented by the government as part of the Poverty Reduction strategy. While the SLP significantly contributed to enlarging credit access of poor farmer households, it suffered from various governance weaknesses. Microfinance initiatives undertaken by NGOs and the government have allowed for better outreach and better repayment performance. As of 1999, average micro-credit outstanding was about 30 per cent of GDP.

In contrast to many developing countries, the formal financial sector has been rather effective in mobilizing savings of poor and low income households. But, just as in many developing countries, the provision of microfinance services has taken place outside of the sector and is still largely considered as a separate tool for poverty alleviation. However, in recent years, financial sustainability concerns have arisen due to the fact that microfinance schemes are primarily project based and heavily dependent on subsidies. These concerns have led to exploration of new ways of integrating microfinance into the formal financial sector. The Agricultural Bank of China and the RCC network have recently carried out experiments along these lines. In early 2000, the government indeed took significant steps to improve access to formal credit in rural areas with the introduction of household micro-credit through rural credit cooperatives. Results have been notable. RCCs provided microfinance loans and services in most provinces in 2001 and 2002. As a result, the share of loans to farmers in total RCCs loan outstanding in 2002 was above 30 per cent, 4 percentage points higher than in 1997.

Thus monetary and financial reforms have had important implications for the poverty reduction objective. Monetary policy changes significantly influenced the effectiveness of expansionary monetary policy measures in tackling deflationary pressures. And since the primary goal of financial sector reforms in the 1990s was to prevent financial instability, they did not address a range of issues that appear critical from a poverty reduction perspective. This includes ensuring that financing requirements of the private sector and especially small and medium sized enterprises are adequately met, and more directly, ensuring a sustainable access to finance in the rural sector, especially for poor and low income rural households.

6. **Policy implications**

The above discussion makes clear that from the point of view of evolving a strategy for poverty eradication, growth is a necessary but by no means a sufficient condition. The nature of growth, or whether it is accompanied by increasing inequality, rising food prices, inadequate support for or public investment aimed at generating rural non-agricultural employment and public action aimed at redressing social deprivation are all
of relevance. This need for a combination of prerequisites for poverty alleviation implies that growth needed to reduce poverty cannot be based purely on the functioning of market forces, assuming that markets can deliver growth at all. As the UNDP’s Poverty Report 2000 puts it: “Markets don’t promote social justice. That takes public action. And that implies a need for an anti-poverty plan – the evidence of a national commitment to eradicating poverty.” (UNDP 2000: 32)

Further, from the point of view of this paper, what we need to consider is the effects of alternative financial regimes on the above-mentioned proximate determinants and the effort to leverage relevant policies to influence those determinants in directions that help alleviate poverty. The conclusion that emerges from the case studies is that the move away from directed credit and differential interest rates results in a worsening of the deflationary stance that results from the fiscal contraction and tighter monetary policy framework associated with financial reform. This is largely because of the contraction in credit provision associated with financial restructuring and a rise in interest rates due to the larger spreads necessitated by the new environment. In addition, the new prudential norms including rapid reduction in non-performing assets and improved capital adequacy ratios also restrict credit expansion. In countries in transition, these problems are worsened by the effects of the restructuring of state-owned enterprises, which increases unemployment, restricts demand expansion and increases the losses of enterprises that can be funded by the restructured banks.

Moreover, the squeeze in credit availability affects most adversely the access to credit of agricultural and small enterprises. Since this occurs at a time when public investment in rural infrastructure is being curtailed, the consequences for growth in the rural areas and for the expansion of urban SME are adverse. Since these are segments that are crucial from the point of view of poverty reduction, financial liberalisation more often than not limits the poverty-reducing consequences of whatever growth occurs.

Liberalisation also increases the fragility of the financial sector, increases instances of financial bankruptcy, renders the system prone to the adverse external effects of such events and increases the possibility of large-scale financial crises. These features too create a deflationary environment and can have extremely negative consequences for the poverty reduction effort.

The country experiences suggest that, despite efforts to use new means to continue with directed credit (as in Vietnam) or to rely on new institutions like micro-finance enterprises to reach credit to the vulnerable sections, financial liberalisation has indeed substantially reduced the prospects of pro-poor growth, without contributing very much in the form of improved allocational efficiency. This suggests that liberalising the domestic financial sector and easing cross-border flows of capital are not the best options for developing countries in their still early stages of development. They need to adopt financial policies similar to those adopted by the present day developed country when they were at similar stages of development. The more developed among the developing countries would of course need to move away from classical forms of so-called financial repression. But they too need to relax regulation in a manner that ensures that they
maximise benefits (for example, by encouraging FDI as compared with portfolio capital flows, as in China), generate new institutions backed by the state to direct credit to rural areas and the SMEs, and limit the increase in the fragility of the financial system.