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Capital Market Liberalization, Poverty and Inequality

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I. INTRODUCTION

Linkages between international financial flows and underlying levels of human development - the ultimate focus of development economics and the international development institutions alike – continue to be neglected in both academic and more directly policy-oriented research. Economic theory (including that of development economics) remains overwhelmingly addressed toward growth, while the weaknesses of inequality and poverty data continue to restrict quantitative analysis. The impact of capital account liberalisation (CAL) on economic growth has however been a focus for empirical work, partly due to better data availability. An important driver of this research has been the contradiction between theoretical predictions of growth benefits to free capital flows, and the apparent absence of such benefits in practice. Recent surveys of this empirical work have found – after twenty years of liberalisation's prevalence – that there is little or indeed no serious evidence of growth benefits – see e.g. Arestis & Demetriades (1997), Cobham (2002), Singh (2002) and now Prasad et al. (2003).

The latter's acceptance of this case – published while co-author Ken Rogoff was still Chief Economist at the IMF – is noteworthy. Many economists have criticised that institution for its persistent adherence to CAL, so Rogoff's contribution underlines the breadth of acceptance of the 'unproven or worse' verdict on CAL's growth benefits.[1] There is now widespread agreement that such benefits may not in fact accrue, and that positive results may be especially unlikely for poorer countries. As Cobham (2002) argued, it becomes critical in light of this recognition to pursue research into the poverty and inequality impact of CAL. The absence of growth benefits greatly strengthens the possibility that misguided liberalisation advice may have had – and may have in the future – serious costs in human development terms. That paper presented an early attempt to trace the linkages between CAL and poverty, as the embrace of poverty reduction as a central goal of the international financial institutions had not then yielded such analysis. The theoretical elements of the present chapter are in large part an attempt to pursue avenues for research identified there. Poverty linkages to CAL are considered to occur through two main channels; effects on government finances, and effects on industrial structure and performance.

There has not been extensive overlap between research on the themes of poverty and inequality and that on capital account liberalisation. Indeed, there are significant differences in typical style and approach. While poverty research has typically been case-study driven (e.g. Nicholls & Hunter, 2000) or highly conceptual (e.g. Anand & Sen, 2000), that on CAL has instead either focused on cross-country econometric analyses of growth effects (e.g. Klein & Olivei, 1999), or else tended toward consideration of issues of practical macroeconomic management. The latter have been generally more open to considering distribution issues beyond a pure growth focus (e.g. Frenkel, 1998 assesses the employment and income distribution effects of Latin American liberalisations).

A number of recent papers have attempted to bring together the findings so far of research on the poverty outcomes of macroeconomic policy generally. Cashin et al. (2001) survey this body of work[2] and conclude that 'the current state of knowledge is that economic growth is associated with improvements in indicators of well-being' but find that little is known about the effects of specific macroeconomic policies. They end by questioning the value of further cross-country studies and suggesting that case studies are more likely to yield insights (see also the survey of Gunter, 2002). One particular problem is the lack of agreement on the definition of, and approach to, poverty measurement. Ruggeri Laderchi et al (2003) provide a survey and empirical comparison of the main approaches , but for the purposes of this chapter, only a broad definition of poverty is required. While monetary poverty and inequality are treated as important throughout, a broader conception following the capabilities approach is intended; one which also embraces the provision of healthcare, education, institutions of government and society necessary for some minimal levels of security and stability, and rights to self-determination.

The most detailed work on the distributive effects of CAL is the body of 'structuralist' analyses conducted by Lance Taylor and others. Taylor (2000) introduces a collection

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[1] See Reisen's chapter in this volume for a full survey.
[2] It is worth noting the headings used: 'Poverty, Income Inequality and Economic Growth'; 'Inflation and the Poor'; 'Trade Liberalization and Poverty'; 'Poverty and External Debt'; 'Macroeconomic Crises and Poverty'; and 'Fund Programs and Poverty'. The topic of this chapter is the notable absentee – there simply does not exist sufficient research on CAL and poverty to justify a full survey section.

of 21 country case-studies assessing the impact of external (i.e. current as well as capital account) liberalisation on economic performance and distribution.[3] The basic model used is a 'fix-price/flex-price' model, driven by a separation of the traded and non-traded goods sectors. The studies point toward redistribution of production and income from the former to the latter, and widening income disparities between skilled and unskilled workers. To the extent that generalisations can reasonably be made about the variety of country experiences examined, the following pattern is broadly representative.

Episodes of capital account liberalisation were followed by capital inflows, and exchange rate appreciation resulted with the concomitant increase in variable costs of traded goods. Higher interest rates followed booms in asset (mainly housing and equity) markets, led by credit booms, and also sterilisation of inflows where this was attempted. Financial institutions were often able to take advantage of weak competition and increase spreads. Higher interest rates and the possibility of returns from high spreads encouraged more capital inflows and hence further exchange rate appreciation, but of course appreciation also encouraged higher interest rates. Current account liberalisation often occurred to this background of strong exchange rates, high interest rates and a credit (and asset market) boom. It generally took three forms: transformation of non-tariff barriers (NTBs) on imports into tariffs, compression of tariff rates to a relatively small range above zero, and the removal of export subsidies.

The impacts were broadly these:
- demand shifts towards imports (backed by exchange rate appreciation, and resulting from a profit squeeze in the traded sector and a growth of credit-funded household spending), creating the potential for domestic output (growth) to fall;
- falling domestic savings rates, sometimes accompanied by rising government savings;
- reorganization of traded goods sectors, with increases in labour productivity growth often resulting from a fall in total employment, with unskilled labour

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[3] The countries studied are primarily but not exclusively MICs from the Latin American and Caribbean region. They are: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominican Republic,

bearing the brunt and hence increased skilled/unskilled wage inequality. The non-traded sector sees increasing employment (and falling productivity, hence falling wages and increasing traded/non-traded wage inequality) so overall employment effects are ambiguous;

- rising trade deficits 'require' higher capital inflows.

Other, often contemporaneous areas of liberalisation also contributed. Domestic financial liberalisation - both deregulation (e.g. of interest rates, reduction of reserve requirements) and opening (to entry by new (including foreign) banks and other financial institutions - contributed to the credit expansion, and with inadequate regulatory infrastructure these laid the grounds for financial crises to come. Labour market liberalisation had progressed little in the sample countries, with segmented markets and institutional wage setting still prevalent, although reductions in union power may have occurred. Liberalisation (or at least restructuring) of tax systems favoured consumption over income taxes, and may have shifted the burden from corporate and higher income groups towards the rest of the income distribution.

Table 1: Growth and distribution effects of external liberalisation

	Distributional impacts		
Effect on growth	**Favourable**	**Neutral**	**Unfavourable**
Positive	Chile (post-1990)	Peru Uruguay	Argentina (until 1997-8) Chile (until 1990) Dominican Republic El Salvador Mexico (post-1995)
Neutral	Costa Rica	Brazil Cuba Turkey	India Korea Mexico (until 1995)
Negative		Colombia	Argentina (post-1997/8) Jamaica Paraguay Russia Zimbabwe

Source: Taylor (2000), adapted.

Table 1 shows the overall outcomes of external liberalisation for both growth and (income) distribution, which Taylor characterises as giving the impression of a tilt towards the southeast. What can certainly be said is that, despite a relatively even spread of growth outcomes (between positive, neutral and negative), the distributive impact was overwhelmingly negative. The type of growth which resulted from

Ecuador, El Salvador, Guatemala, Jamaica, Mexico, Paraguay, Peru, Uruguay, India, Korea, Russia, Turkey and Zimbabwe.

policies of external liberalisation was anything but pro-poor; and in the many cases where growth did not occur, worsening distributions were the main impact.

Few papers have undertaken analyses of capital account liberalisation which go much beyond income distribution in considering the impacts on poverty. Singh & Zammit (2000) focus on the gender dimensions of capital flows, find a range of obstacles to gender equality posed by the structure of international financial markets. They issue a call for organised pressure to be brought to bear to ensure gender inequalities are neither generated nor maintained by processes related to international financial flows. FitzGerald (2002) considers the implications of financial globalisation for child well-being. His model focuses on linkages to employment levels and labour incomes as the main linkages by which child welfare is affected. The model is based on a three-way segmented labour market – the 'Corporate and Government', 'Urban Informal' and 'Rural Peasant' sectors. It draws out the linkages (during financial crises) from the first sector, to the poor who are involved in the other two. A calibrated model shows urban informal employment losses in excess of the initial fall in corporate employment but less than full 'pass-through' of reductions in corporate wage levels. Table 2 shows the values which emerge.

Table 2: Poverty responses to financial crisis

		Corporate sector	Urban informal sector	Rural sector
10% fall in corporate sector employment	Employment	-10%	-16%	+6%
	Wages	-	-6%	-6%
10% fall in corporate sector wages	Employment	-	-6%	+4%
	Wages	-10%	-4%	-4%

Source: FitzGerald (2002), from a calibrated model of segmented labour markets.

The analysis leads FitzGerald to call for the reconsideration of capital controls, as well as a number of international measures designed to stabilise flows. This new international financial architecture 'must be underpinned by sound social protection systems in order both to protect vulnerable groups… and maintain political consensus on sound economic policy' (p.15) as was envisaged in the Bretton Woods agreements. In the same volume, Cornia (2002) lists the following economic factors as exacerbating child poverty: the decline in the poverty alleviation elasticity of growth since the 1980s, a deceleration of that growth in many countries and its growing

volatility and resultant sharp jumps in poverty rates. Baldacci et al. (2002) focus on those latter effects of financial crises, and present macro- and micro-level data on the extent of the poverty increases involved, along with evidence of inequality increases in *some* cases only.

While the effects of macroeconomic volatility are given serious consideration in what follows, the cause and effects of specific economic crises are not. It is the intention to focus on the longer-term structural effects of liberalisation. We do not seek, for example, to compare the likelihood and costs of financial crisis (e.g. Detragiache & Demirguc-Kunt, 1998, Kaminsky & Reinhart, 1999) after external and domestic financial liberalisation, or the poverty and inequality impact of crises (e.g. Lee & Rhee, 1999) with the possible one-off growth benefits of stock market liberalisations (Henry, 2003).[4] While the impact of crises is clearly important, research is ongoing into their origins and mechanisms for avoidance, and the appropriate response to ameliorate the poverty effects. Given the absence of evidence for overall growth effects of CAL, and Baldacci et al.'s inequality crisis finding, the main effects on poverty and inequality are likely to be through (long-term) structural changes in the economy – rather than short-term impacts related to economies' positions vis-à-vis trend growth.

For this reason, this chapter examines the impacts of periods of inflow and reversal in a more general setting. Section II assesses the linkages which operate through the channel of government finances, section IV those through financial markets and industrial structure. Section V sets out conclusions and makes some suggestions for policy options and further research.

II. GOVERNMENT FINANCE LINKAGES

The human development impact of capital account liberalisation via government finance occurs through three paths, which are postulated to affect poverty and

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[4] Das and Mohapatra (2003) show that these booms were characterised by a 'pattern indicating that income share growth accrued almost wholly to the top quintile of the income distribution at the

inequality through changing both the level and volatility of social expenditure, infrastructure expenditure and private investment. Instability of government finances – the volatility of revenue and expenditure – leads to uncertainty surrounding future allocation and distribution. The freedom of allocation – the level of expenditure which governments are able to set – has obvious effects on social expenditure. Freedom of distribution concerns the ability of governments to redistribute income, both positively (i.e. through expenditures) and negatively (i.e. through taxation).

Stability of finances

Despite the consumption-smoothing benefits which theory predicts from CAL, its effects on macroeconomic fluctuations are indisputably adverse. Given that levels of government revenues are closely related to levels of economic activity, CAL will directly increase the instability of expenditures. Reductions in the *level* of government finances, which are explored below, have costs, but so too do reductions in their stability. When revenues are volatile, the ability to commit to programs of expenditure is undermined. This has potentially serious costs for poverty and inequality, as well as consequences for economic growth. Given imperfect financial markets, the poor are unable to smooth their consumption efficiently and will therefore be more exposed to both macroeconomic fluctuations and fluctuations in government provision. As well as undermining the stability of those who rely on transfers to attain some minimal standard of living, instability of government finances also reduces governments' ability to attract complementary private investment, hence reducing their overall potential to assist economic growth.

Toye (2000) details the relative instability of various sources of finance for the governments of a panel of 48 poorer developing countries, as shown in Table 3. Most unstable (after capital revenues, which are generally insignificant) is aid revenue. Pallage & Robe (2001) show how flows of official development assistance (ODA) are systematically much more unstable than recipient countries' GDP. ODA flows are less volatile than private flows, especially in the poorest countries, but their potential contribution to instability may be equally great because of their importance as a

expense of… the three middle quintiles of the income distribution [while] the lowest income share remained effectively unchanged' (p.217).

percentage of recipient GDP. This is especially high in the poorest countries – among the African countries examined by Pallage and Robe the average stands at 12.5% of GDP in 2000.

Aid inflows are also overwhelmingly procyclical. The same authors find that more than two-thirds of African recipients in their sample face aid receipts with a cyclical component which is significantly and positively correlated with the cyclical component of domestic national output. This relation is inverted – i.e. aid receipts are *counter*-cyclical – for just two African countries from a sample of 38, and four non-African recipients from a sample of 25. The importance of aid for the smallest, poorest countries makes this volatility highly undesirable.

Table 3: Instability rank of government finance sources, 1970-91

Rank	Source	Coefficient of variation
1	Capital revenues	1.75
2	Aid	0.99
3	Capital expenditure	0.87
4 =	Foreign exchange reserves	0.83
	Current expenditure	0.81
	Current revenue	0.79
	Total expenditure	0.79
	Total revenue	0.78
	Debt and money creation	0.77

Source: Gemmell & McGillivray (1998), quoted in Toye (2000).

The most stable sources of government finance have been debt and money creation. Arguably, given the observed failure of aid to assist in smoothing government expenditures, these are the only stability-enhancing tools available. However, money creation has significant inflationary consequences, and inflation has costs for the poor in particular because of their inability to acquire 'inflation-proof' assets. The poor in the formal sector are also subject to the phenomenon of 'fiscal drag' – the impact of inflation in effectively lowering the level of income tax bands – which is extremely regressive in income distribution terms. The presence of the poor in the formal sector is of course more widespread in wealthier developing countries. The poorest may not rank inflation highly as a problem however – because they neither operate in the formal sector nor are able to acquire significant assets, inflation-proof or otherwise.

Recent research shows that CAL has been strongly correlated with reductions in inflation over the 1990s (Gruben & McLeod, 2002). This implies that even if the benefits of more stable government finances from money creation might have outweighed any costs to the poor from inflation, such a choice was generally not taken – possibly for the reasons of 'market discipline' discussed below. This leaves debt as the sole most effective tool for governments to smooth their expenditures. CAL opens domestic bond markets to international investors, and hence should allow greater liquidity for governments. However, as is discussed in the following section, the implications of 'market discipline' for government debt is to increase its costs in terms of the possibility of breaching some level which prompts investors to reassess their exposure and reverse capital inflows. The problems associated with sterilisation (also detailed below) may also apply.

It seems inevitable then that CAL will increase the volatility of government finances. Increased macroeconomic fluctuations drive instability of tax revenues, while money creation and debt as expenditure smoothing mechanisms are each made more costly by 'market discipline'. The volatility and pro-cyclicality of aid flows imply a clear policy response for donors to ODA countries (indeed this holds regardless of whether CAL is pursued). Greater conditionality such as that embedded in the Millennium Challenge Account is unlikely to promote stability and nor will it therefore maximise the poverty reduction potential of the allocated funds. The general problem of revenue instability provoked by CAL would not be overcome by even perfectly counter-cyclical aid however, and the position for non-ODA countries will remain.

Freedom of allocation

The extent to which government is able to vary the levels of allocation of government finances may be severely restricted by CAL. This occurs in two ways: through the direct costs of managing capital inflows, and through the 'market discipline' impact of accumulated inflows. It is not assumed that governments unrestrained by liberalisation will necessarily follow efficient pro-poor growth strategies. Evidently however having stronger finances allows governments greater freedom to choose such

a strategy. Reductions in this freedom – cuts in expenditure – have serious consequences for poverty.

Biggs (1998) shows that fiscal cutbacks in developing countries have historically targeted investment most heavily, while providing relative (but far from complete) protection to wages and transfers. Table 4 illustrates the observed effects of declining real expenditure, from data on 28 developing countries for periods when the reduction was 5% or more. Most direct for the poor will be the effect of even the disproportionately small cut in transfers (under 'General public' expenditure). Despite the relative protection afforded to this category of spending, the impact may be great nonetheless, since transfers to the poorest will form a very great part of their total incomes; and these are incomes they can already ill afford to see cut. Social sector expenditure – expenditure on health and education – is protected to an extent, bearing two-thirds of the proportionate reduction in spending. Spending on countries' infrastructure suffers the most in the sample periods, followed by productive investment.[5]

Table 4: Expenditure trends during periods of real declines, 1970-84

	Reduction (%)	Elasticity
Total expenditure	16.8	1.00
General public	9.2	0.53
Defence	6.25	0.38
Social sectors	11.25	0.66
Productive	18.7	1.08
Infrastructure	25.4	1.47
Others, including interest	1.4	0.08

Source: Hicks (1991), quoted in Toye (2000).

Reductions in the level of government's expenditures have a range of poverty-related impacts. On the whole, the effects appear to reflect a relatively high discount factor (as might be expected of political systems with short time horizons, such as

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[5] One caveat to this concerns the measurement methods used to assess 'real' expenditure. Collier & Gunning (1999) show how important it can be to use sector-specific deflators. In the case of the Zambian liberalisation, over the period 1991-96, using a GDP deflator reveals a 9% reduction in healthcare spending and 28% in education. However, prices in the sector (and especially real wages) were moving independently of GDP, and when sector-specific deflators are used, the implied changes are apparently positive; Collier & Gunning find increases in healthcare spending of 27% and in education of 24%.

democracies with fixed terms of government of several years). Levels of direct transfers, which will have the most immediate impact on monetary poverty, are relatively protected. Reductions in expenditure will impact more heavily on health and education – but will take time to feed through the system, while infrastructure investment (required to enhance *long*-term growth and human development prospects) suffers most. Outside of crises, the relative importance of government spending in the economy may be higher in the small LICs than in wealthier MICs; and certainly the marginal social return to infrastructure investment in LICs *should* be higher, given its greater scarcity.

CAL most directly reduces the overall level of government budgets available for fiscal expenditure by diverting expenditures to other avenues; in particular, to managing the associated capital inflows. As governments build foreign currency reserves in response to inflows, in order to reduce the resulting upward pressure on the exchange rate, they face a choice between unpalatable alternatives. The counterpart to their reserves is an increase in the domestic money supply, which generates inflationary pressures if unchecked. Sterilisation by bond issuance is the alternative, with the net result that the government has increased its liabilities and assets by equal amounts.

Assuming these reserves are held as interest-bearing assets, commonly US Treasury bills, the price to the government of these manoeuvres – omitting transactions costs – will depend on the interest rate differential between the developing country and (in this case) the US rate. Although there are of course other benefits to holding reserves, the costs of this inflow management policy can be startlingly high. Stiglitz (2000) gives the following example. If a company in the developing country borrows $100m from a US bank, then since it is perceived as relatively highly risky, it must pay 20% interest. If the government holds foreign exchange reserves (in US T-bills) to offset this borrowing, it receives 5% interest. The annual cost to the poor country of this arrangement is then $15m.

The cost to the government, if it is carrying out full sterilisation, may be different. If the government has sold bonds to the value of $100m, to maintain a stable money supply, and – being relatively risky, but less than the company in question – pays 15%

on this debt, the direct cost to the government is $10m a year. For the small LICs, where aid flows form a larger part of government budgets, such a policy to maintain exchange rate stability will have disproportionately high costs in foregone expenditure. Note that a similar calculation for sterilising all net inflows to developing countries would imply a cost of $40bn for 2001.[6] For sub-Saharan Africa and South Asia alone (excluding India and South Africa), this implies direct costs to CAL of $5bn – an effective outflow equivalent to *30% of total aid flows* of $16.9bn.[7] An alternative calculation would be to apply to observed reserves in 2002 an interest rate differential of, say, 5% for the East-Asia Pacific region and Latin America and the Caribbean, 10% for the small LICs and the large closed economies (sub-Saharan Africa, South Asia and China) and 7.5% for MENA and Eastern Europe and Central Asia. This yields an estimated annual cost of holding foreign exchange reserves of $56bn. For sub-Saharan Africa without South Africa, and South Asia without India, the cost is $9.9bn – more than half the aid contribution.

It is also unlikely that a long-term sterilisation policy can be successfully sustained, since the issue of more bonds (presumably at the same or a higher interest rate to ensure sufficient demand) may exacerbate interest differentials and hence both increase the costs and encourage further inflows. One other negative impact of sterilisation is that – as has been observed in small LICs especially – government issues can dominate the bond market to the exclusion of other issuers except the very largest corporate groups. In other words, following a policy of sterilisation may aggravate the difficulties for domestic industry of raising debt finance for investment.

In the case of potential *downward* pressure on exchange rates, an alternative to sterilisation is provided by the IMF's 'monetary programming model'. Government policy is assumed to aim to prevent a depreciation of the exchange rate because of the passthrough to inflation: that is, imports (and then domestically-produced tradables) become more expensive, while cheaper exports increase the foreign demand for

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[6] Data from Global Development Finance, 2003. Honohan (2003) provides evidence of the rise in real interest rates as (domestic and international) financial liberalisation progressed. Since CAL should in theory provide momentum to a process of equalisation of *risk-adjusted* rates, and developing country governments' debts are relatively risky, this implies that they are likely to have to pay a higher real (non-risk-adjusted) interest rate on their liabilities (bonds issued) than they receive on their reserve assets (T-bills purchased), although not necessarily by as much as the 15% Stiglitz uses.

domestic production – which in turn drives up domestic prices too. Governments are therefore holding monetary policy tight to combat inflationary pressures. Autonomous inflows (of foreign capital) reduce the downward pressure on the exchange rate and allow a relaxation of monetary policy (and hence increased growth), while outflows increase downward pressure and require a monetary contraction.

While this appears to represent a beneficial response to inflows (if the underlying assumption of downward exchange rate pressure is reasonable), there are obvious costs. Policy will necessarily follow the cycle of foreign capital flows (which are highly pro-cyclical with countries' economic conditions), rather than acting to stabilise the economy. The model encourages pro-cyclical government policy and hence increased macroeconomic volatility. The choice between sterilisation and programming is not an attractive one – management of capital inflows will have costs in terms of increased instability of both government finances and the macroeconomy more generally, and also of quite significantly reduced levels of expenditure (under the sterilisation case at least).

The second key linkage by which CAL affects the level of government finances is the mechanism commonly referred to as 'market discipline'. In theory, governments are disciplined into 'good' economic policies. In practice, rather than restricting governments to some carefully considered commitments, it simply reflects the sensitivity of investors to certain government policy variables – not the least of which being the extent of liberalisation and levels of inflation and external debt. 'Good' policies are effectively those which investors perceive as consistent with strong investment returns.

Since investors base their decisions on only a very narrow range of information, changes over a small range in a few variables can lead to very rapid adjustments of investors' portfolios. These include the level of government deficits, inflation (or expected inflation) and short-term indebtedness ratios in particular. This apparent myopia is in part determined by the evaluation methods of the influential international

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[7] Data used here for sub-Saharan African aid flows (but *not* other inflows) include South Africa, so this figure underestimates the relative cost of sterilisation.

credit ratings agencies.[8] This is of course greatly exaggerated by the apparent existence of 'tipping points' at which investors suddenly reassess known data and reach different conclusions on countries' continuing creditworthiness.

The importance of avoiding reversals once significant in-stocks have accumulated therefore ties government hands in important areas of macroeconomic policy: market discipline acts as a deterrent against allowing high levels of inflation or running fiscal deficits.[9] It is interesting to draw out some implications of this. On the one hand, if fiscal deficits are used by (some) developing countries to *efficiently* promote investment, growth and poverty reduction, then the 'discipline' of CAL contribute to increasing poverty. This will occur directly, through reduced scope for counter-cyclical government spending – on transfers and social expenditure, and indirectly, through reduced investment and growth – from more volatile, reduced public (and therefore private) investment in infrastructure and productive assets. On the other hand, where governments are using fiscal deficits *inefficiently*, the 'discipline' should curtail the wasteful use of limited resources as is claimed by CAL's proponents. Crowding out of private investment by inefficient government expenditure may cease, with concomitant positive effects for investment.

This explains a preliminary result found by Kraay (1998): that "investment is significantly *more* likely to increase [after CAL] in countries with *bad* policies/institutions than in *good* countries" (p.24). Kraay suggests that this may stem from the superior ability of 'good' countries to prevent irrational post-liberalisation booms; but in light of the near omnipresence of such booms, this 'discipline' explanation seems more likely. If market discipline does restrict good policy-making then, CAL will have the highest costs for relatively *well*-governed economies but potential benefits for the badly-governed.

Freedom of distribution

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[8] Collier & Gunning (1999) refer to two particular pieces of work reflecting the underlying flaws: '…Haque et al. (1998) show that while the three major investor risk ratings are largely explicable in terms of policy fundamentals, they have a high degree of persistence and the dummy for Africa is large and significant. Hence, newly reformed countries in Africa find that their ratings are slow to change, and that they are contaminated by a 'bad neighbourhood' effect. Jaspersen et al. (1998) show that the risk ratings are significant in regressions of private investment' (pp.11-12).

Government's ability to redistribute income through the tax system and through expenditures is also undermined by liberalisation of the capital account. As noted, macroeconomic volatility may make tax revenues increasingly variable because of the instability of the underlying output, employment and investment. The level of expenditure may well become both lower and more volatile. Also of concern is the possibility that liberalisation-related changes will limit government's abilities to redistribute income – either positively through directed expenditure or negatively through directed taxation. Of the latter, we focus here on the impact of increased capital mobility on the incidence of taxation, and the effects of tax competition between countries.

The findings of Doolley & Kletzer (1994) imply that when domestic financial markets are liberalised and it is known that outward flows will not be unduly restricted, the stock of domestic flight capital held abroad tends to reassert a 'home bias' and return to the market in significant quantities. Although new flight becomes easier, the actual effect of liberalisation may be to increase domestic investment by domestic capital-holders.[10] The more particular danger concerning the potential for large-scale 'flight' is that it will lead to the tax burden falling more heavily on the less mobile factor – labour.

To encourage inflows and avoid inducing capital flight, governments have an incentive to tax capital less. Since workers are relatively immobile, the tax burden will fall more heavily on labour. This has regrettable distributive implications. The (relative) reduction of taxes on capital is in effect a reduction of taxes on those with greater wealth. Moreover, taxing labour more instead affects the poorest most heavily – their income from work forms a proportionately larger part of their total income than that of capital owners. This effect of *potential* capital flight is compounded by a different effect of *actual* outflows, and hence may be stronger during downturns.

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[9] [14] The results of Gruben & McLeod (2002) 'suggest that full capital account liberalisation is associated with a 3-6% fall in average inflation rates' (p.225).
[10] See FitzGerald & Cobham (2000b) for a survey of capital flight and related issues.

Outflows will erode the tax base (by reducing the total stock of taxable capital and labour in the economy). Even if the tax structure is unchanged by capital flight, proportionally more tax will fall on the remaining capital and labour. Since the percentage of transferable (capital) assets of a person will generally be lower, the poorer she or he is, the poor are least able to avail themselves of the potential for capital flight and therefore suffer most from the changed balance of taxation. The very poorest will be protected to the extent that they are not in fact part of the formal economy, and hence unaffected by changes to the taxation system. However, changes which increase the burden of taxation on labour will inevitably increase the disincentive for the poor to move into the formal sector, and thus may both restrict economic progress and prolong one form of social exclusion.

Tax competition between developing countries for capital flows, and in particular for FDI, provides a slightly different mechanism for the same effects to occur. Many developing countries seek to attract foreign investment through tax incentive policies in an attempt to compensate for local distortions and inefficiencies, or to simply prevent foreign investment from going to neighbouring or similar countries. Many *industrialised* countries spend significant resources in seeking to attract FDI.

However, such incentives play a limited role as determinants of foreign investment, and even where successful – e.g. in some export promotion zones - involve significant fiscal costs.[11] Tax competition affects the poorest countries most, and disproportionately so. Haufler & Wooton (1999) show how tax competition between industrialised countries for foreign direct investment can lead to all of the benefits of investment being obtained by the multinationals. KPMG's annual reports on corporate tax rates show consistent reductions across the OECD. This justifies the OECD and EU measures taken to prevent such harmful competition between their respective members.[12]

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[11] See, e.g., UNCTAD, 1999: "There was consensus [among the experts assembled by UNCTAD] that while [tax] incentives have their pros and cons, their role essentially remains subsidiary. More fundamental factors are political and economic stability, project feasibility, market considerations, investment climate and infrastructure" (p.9). As discussed above, the impact of CAL on these need not be positive; but it would be a further mistake for policymakers to react by offering greater incentives.

[12] Both the OECD and the EU have recently adopted non-binding instruments for dealing with potentially harmful preferential tax regimes – in recognition of the dangers for industrialised countries of such competition. FitzGerald & Cobham (2000a) emphasise the importance of the association of non-OECD countries with these.

The problem is more acute for poorer countries, however, since individually they face even higher tax elasticity of investment. That is, the level of direct investment is likely to be more sensitive to the tax rate in a small developing country than in a large bloc of industrialised countries like the EU. This effect occurs because the cost of ignoring one small developing country is also small for the multinational. Region-wide agreements such as the EU's increase the economic importance of the players, and hence reduce the tax elasticity of investment. While this may provide some respite, however, ultimately the only solution is a universal one which involves both developing and industrialised countries together.

The effects of one developing country acting unilaterally to stop tax competition for FDI would simply be to eliminate a large part of that country's FDI flow. Only by working together can governments prevent the benefits being competed away to the multinationals. One could argue that the policy implications for small LICs are simply: be richer, or be China or India, in order that your market is sufficiently valuable that you can exert greater control on the tax treatment of multinationals. The quickest route to market enlargement is not through growth (economic or population), however, but rather through international co-operation. A well-functioning sub-Saharan agreement for example might allow each country somewhat more policy freedom, if the commitment to co-operate was credible and the gains large enough to withstand the carrot of any given investment in any given country.

While foreign direct investment is generally acknowledged as the most positive form of capital flow to liberalise, agreement on tax and subsidy competition is necessary to ensure some of the benefits accrue to the host countries and that tax revenues are not unduly undermined. Finally, it should be noted that tax competition for portfolio investment does not occur in the same way. While long-term investments can be attracted by one-time payments or subsidies,[13] portfolio investment is instantly reversible, so ongoing payments (or perhaps subsidies on Chilean-type capital controls?) would be required.

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[13] Although it is likely that one-time payments attract investors who behave more according to short-term cost minimisation than long-term profit-maximisation – and are therefore less likely to make long-term irreversible investments but rather move on when short-term cost conditions (e.g. exchange rates) move against them.

However, competition for portfolio investment does appear in different forms. This involves deliberate government measures to facilitate the use of tax havens or loopholes. For example, the BIBF in Thailand has been used to funnel low-tax capital into the country, and in particular was heavily used in the post-crisis 'fire-sale' of domestic assets to international investors. India's attempt to prevent the use of Mauritius as a tax-avoiding point of entry to the country's capital markets was quietly abandoned for fear of chasing away investment.

The phenomenon extends beyond developing countries too; for example, the deliberate US loophole which results in the British Virgin Islands being technically responsible for almost as large a share of US banks' liabilities as the UK itself.[14] Arguably, this may be *more* damaging than FDI competition, since it does not even allow governments any opportunity to be selective – whereas in the latter, subsidies can at least be directed to the chosen industrial sector or regional location. There is as yet no serious body of research on competition in the use of tax havens and other avoidance measures, and their developmental implications.

Positive redistribution occurs through government expenditures rather than taxation. Two elements of the impact of CAL are worth highlighting. Firstly, the political 'zone of possible agreement' (ZOPA) between government and governed is restricted in a number of ways. The 'market discipline' channel both limits the range of deficits and short-term indebtedness which will not be punished by capital outflows, and also reduces the range of 'acceptable' stances on the extent of government intervention in markets. Redistribution, for example, has been identified both as a policy promoting human development and then growth (e.g. Ranis & Stewart, 2001) and as a moral imperative for a globalising world (Honderich, 2002) – but any serious contemplation by a government of effective land reform for policy discussion would threaten a reversal. The redistributive potential of government finances is similarly undermined, both shifting the burden from capital to labour as outlined and possibly also restricting the extent to which transfers can be used to protect the poorest (even when the overall level of finances allows this).

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[14] US Dept of Commerce data – see FitzGerald & Cobham, 2000a.

A further concern on the impact of CAL relates not to restrictions on the ZOPA but to the process of reaching agreement – the poverty impacts of this 'discipline' of governments go beyond the pure effects of restrictions on policy choices. Participation in decision-making, and the ability to make genuine political choices (at the ballot box or elsewhere) are both important parts of the package of capabilities which comprise a condition of non-poverty. Numerous papers discuss the effect of aid conditionality (or the 'post-conditionality' of the PRSP process) on democracy and civil society (see e.g. Stewart & Wang, 2003 or Eurodad's 'Matrix of PRSPs' at www.eurodad.org), but rather fewer consider the effects of private capital flows.

The undermining of government's ability to set policy priorities – and hence of the population's ability to redistribute as they choose – may represent a serious increase in social empowerment aspects of poverty. Moreover, the efficacy of the same policies may be weakened if the method of decisionmaking involves less participation by the population, and is perceived as market-imposed. Brinkerhoff & Goldsmith (2003) consider participation in both monetary and fiscal policy. Given the confrontations between different groups in society over taxation especially, they stress the importance of information sharing and consultation in this area. The experiences they survey of participation in public expenditure decisions suggest that these did not produce 'irresponsible' spending, but mainly preferred distributions and more effective targeting. The implication is that even with CAL, there are positive steps to be taken here; but CAL-related restrictions on the political ZOPA may curtail the benefits and emphasise the extent of conflict between foreign capital and domestic society.

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This section has detailed a number of linkages from CAL to poverty and inequality, through the channel of government finances. The overall stability of government finances is undermined by increased macroeconomic instability, and hence greater volatility of tax revenues and required social expenditure. Volatility and even pro-cyclicality of aid flows exacerbate these problems for the poorest countries especially. The level of government finances is also reduced, in the absence of growth benefits,

by the nontrivial costs of managing capital inflows and the restrictions associated with 'market discipline'. The ability of governments to use their finances to address distribution is also limited, by both the 'discipline' of instocks and the relative mobility of capital compared to labour which tips the incidence of tax toward the latter. Finally, limits on governments' room for manoeuvre may weaken democratic systems and ultimately the effectiveness of policies through both inferior targeting and weaker 'buy-in' to policies.

Greater volatility, and lower levels of expenditure can then be expected for the critical areas of social expenditure, infrastructure investment and private investment. Cornia & Reddy (2001) assess the performance of Social Funds set up specifically to offset poverty impacts of adjustment policies, which may be considered to play a similar role to social spending linked to CAL-related volatility. They find that the main reasons for their relative ineffectiveness were these: inadequate resources, insufficiently permanent structures, weak targeting and planning; and above all the failure of public policy to foster 'greater congruence between the objectives of macroeconomic stability and social protection' (p.1).

The impact of CAL on social expenditure then is to provoke exactly those weaknesses that prevent effective social expenditure responding to the macroeconomic instability that CAL also generates. Infrastructure expenditure, essential for poverty reduction in the small LICs at least, has historically been hardest hit by expenditure cuts. The impact on private sector investment crowded in is also likely to be negative. CAL tends to attack policymakers' freedom of allocation and distribution, and is liable to reduce the level, the stability and hence the effectiveness of social expenditure, infrastructure investment and potentially private investment too. The latter is assessed in more detail in the following section.

III. FINANCIAL MARKET AND INDUSTRIAL STRUCTURE LINKAGES

Taylor (2000) and related work assess the short to medium-term impacts of external liberalisation and consider relative productivity and wages of the traded and non-traded sectors. The approach taken here will be to focus more on the longer-term, in

particular through the effects on industrial concentration and the size distribution of firms, and thereby on employment and growth prospects. It is proposed that these effects on structure are driven by three factors:

(i)   differential access of firms to funds through (liberalised) financial markets;

(ii)   greater uncertainty over firms' investment due to increased macroeconomic instability; and

(iii)   foreign direct investment impact.

Uncertainty tends to reduce investment, and the model in Cobham (2001) suggests that the *returns* on smaller firms' investments may be particularly undermined. It is the other factors that are the focus of this section, however. First we consider some general impacts on credit availability for both firms and individuals of financial liberalization. The discussion focuses on the consequences for small and medium-sized enterprises (SMEs), which provide the majority of employment in most (if not all) economies, and so are an important conduit of liberalisation effects for poverty.

Liberalisation and credit availability

Financial sector deregulation – including changes in the freedom both of domestic banks to undertake international transactions, and of foreign banks to enter the domestic market – has important ramifications for the availability and allocation of credit. This can in turn have significant effects on both investment and growth, and employment and poverty. Granting domestic banks the freedom to allocate credit on a pure profit basis can have a number of effects. That predicted by theory is the most positive: simply that banks now compete freely, and hence become more efficient in their credit allocation, make fewer bad loans, support more profitable projects, generate more profits to reallocate and thus facilitate both more and better investments.

Gregorio & Guidotti (1992) find for a set of 98 developed and developing countries that about three-quarters of the positive effects of financial sector development result from this type of effect and hence superior quality of investments, and only the remaining quarter from greater quantity of investment. Even then, Brownbridge & Gayi (1999) survey the changes resulting from financial reforms in eight LDCs – Bangladesh, Laos, Nepal, Madagascar, Malawi, Tanzania, Uganda and Zambia – and

find that only Nepal showed a significant rise in private sector bank borrowing. In other words, observed increases in financial activity may only relate to government operations, and not involve any greater (employment-enhancing) investment by firms.

A further concern stems from the informal sector nature of much developing country SME operations. It is possible – as Taylor (1988) argues – that the effect of liberalisation is simply to shift the origin of SME financing from the informal to the formal sector, and hence there will be no net benefit in terms of investment volume. Kariuki (1995) confirms this for Kenya's financial liberalisation, showing that the average volume of credit among a sample of firms actually fell in every year from 1985 to 1990, except for a 1.5% rise in 1986. The allocative effects in terms of sector and firm size are also unclear. Jaramillo et al. (1992) conclude that, in the case of Ecuador, financial liberalisation led to more technologically efficient firms receiving a greater share of credit. However, these happen to have been also the largest firms, and it was the previously subsidised smaller firms which suffered a credit withdrawal – the impact of liberalisation was to increase credit-rationing among SMEs. If this effect can be predicted then, the question for a government considering liberalisation is whether the positive growth effects of greater credit allocation to more efficient larger firms outweigh any employment costs of reduced credit to SMEs.

The granting of domestic entry to foreign banks and financial institutions would be expected to have similar effects in terms of increased competition and efficiency. Foreign entrants will bring new technologies, new techniques and expertise in risk assessment, which will (at least eventually) filter through to domestic rivals. This should then improve the quality of loans made, and reduce the extent of credit rationing since banks will be better able to assess their limited information on firms.

A number of dangers are also present however. The danger of precipitating crisis is compounded by the possibility of increased competition initiating a number of negative impulses in the sector. Reducing the costs of a branch network may have negative consequences for rural dwellers especially. Since rural branches serve a less densely populated area, they may be the obvious choices for closure. Since rural areas are already relatively under-banked (in terms of geographic concentration, though not necessarily by population), this will further limit the access of a significant section of

the population to financial services. This has potential costs through reduced saving and investment in rural communities, and hence of reduced output and employment (or subsistence) levels, but represents primarily a worsening of rural-urban inequality when already many rural social units are thought to suffer investment-poverty.

Matin, Hulme & Rutherford (1999) point out the success of the Bank Rakyat Indonesia in setting up sub-branch units to reach a mass rural clientele and hence broadening significantly the provision of financial services to the poorest, but this is not a common phenomenon in the wake of financial deregulation. Brownbridge & Gayi (1999) found that entrance into the banking sectors of their eight countries did tend to lead to investment, to longer opening hours, the opening of ATMs, use of debit and credit cards – in other words, increased access to financial services – but only in urban areas. Only the purchase of a rival's rural branch network by Finance Bank (Zambia) went against this trend.

Reducing the costs of non-performing loans and risk assessment are potentially contradictory aims. If banks choose to target the extent of their poor quality loans, this will involve taking greater care with future lending decisions. Investing in improved risk assessment methods and information about potential borrowers should reduce rationing and improve the access to credit of sound businesses (especially the disproportionately rationed SMEs). The easier option however may be to introduce *more* rationing for smaller firms, and focus on larger firms which are less informationally opaque.

Reducing the costs of risk assessment can also involve disintermediation – transferring deposits to (possibly international) capital markets where information is readily available and risks fairly clearly seen, rather than lending them out to businesses. This has obvious negative effects for industry investment and resulting employment and poverty levels, although the risk of financial crisis may be lessened. Even such a large, well-banked market as the USA has taken steps through the Community Reinvestment Act to ensure at least some share of bank deposits are allocated for local business re-lending.

The alternative response to increased competition involves increasing revenues. This will essentially take the form of raising interest rates on lending, but this may be through redirecting lending to higher risk groups or alternatively to (possibly international) capital markets where returns may be higher. The first of these will have the obvious dangers of raising the risk in the bank's portfolio, and without proper supervision can precipitate crisis. The second will reduce the volume of lending available directly to businesses, and hence increase the extent of rationing for smaller firms which cannot access capital markets themselves.

The potential for domestic savings to be channelled abroad to international capital markets will lower the availability of credit to domestic firms, although the entrance of foreign banks may compensate for this. The crisis-inducing possibility is the danger of domestic financial institutions without sufficient expertise or supervision seeking funds from foreign financiers without taking into account the exchange risk or the possibility of short-term loans *not* being rolled over, as in the East Asian crisis. The divergence of private and social costs – given the costs to government of capital inflow management, but also the possibility of higher levels of foreign debt catalysing a sudden reversal of inflows – create a negative externality to CAL.

A key feature of (especially African) developing countries has been the general absence of deposit-taking institutions willing to handle small sums and operating in rural areas. Mosley (2000) notes that this continued unabated after a series of financial liberalisation reforms in Kenya (1982-4), Malawi (1985-7 and 1994-6), Uganda (1992-4) and Lesotho (1994-6). Mosley's findings for the impact of liberalisation on access to credit make unsurprising reading: namely, that liberalisation brought few direct benefits, but the innovation of (especially NGO) credit institutions increased access (to *some* financial services at least) dramatically in both Kenya and Uganda where the NGOs were most active.

More worryingly, even in these cases, the access of the very poorest groups did not significantly increase despite the improvement for more marginal individuals below but closer to the poverty line. Increased competition has *not* had any noticeable impact on the microfinance institutions. That is, despite the success of, for example, the PCEA Chogoria in Kenya and the CCEI/Gatsby Trust scheme in Cameroon,

private sector competitors have not moved in. Furthermore, liberalisation specifically of the microfinance sector has had serious negative effects: in Malawi, the privatisation of the (failing) SACA and Malawi Mudzi Fund led the new company to introduce collateral requirements for its lending, and hence *de facto* disqualify a large sector of the poor from access.

Mosley makes the more general points that while this type of liberalisation may have poverty costs, both policies to promote institutional development and conventional liberalisation of the interest rate (allowing lending at an interest rate of around 40%, as is common among the microfinance institutions in order to cover the high costs of networks in rural areas) can have very promising effects.

Matin et al. (1999) survey financial services provision for the poorest in low-income countries and find two trends in particular. One is a general trend towards more low-level, informal financial intermediation (e.g. the return of deposit collectors in Nigeria after a fall in confidence in the banking system); and the other, more situation-specific responses from formal institutions (e.g. the doorstep financial services offered in Dhaka slums by SafeSave). The paucity of research on the preconditions for CAL to improve (or at least leave unchanged) the access of domestic firms to credit is paralleled by the absence of research to indicate the preconditions for CAL to be at least poverty-neutral. A deeper understanding of the channels involved is required then, even for purely domestic financial liberalisation.

Industrial concentration and FDI

Questions of concentration are explored in detail by Sutton (1991, 1998). He modifies a basic model of firm size to include the predictions of standard theories of firm interaction, and finds that a lower bound on concentration emerges. Where sunk costs are endogenous – in particular, where the returns to R&D and advertising escalate rapidly – then entrance by a large competitor can destabilise markets, and eventually lead to much higher levels of concentration as smaller firms are competed out of business. An entrant can destabilise a market of many small, relatively equal competitors, where they spend *K* times more than the incumbents and the profit made

is at least aY, if the 'escalation parameter' α is sufficiently high.[15] These are referred to as high-alpha industries.

The concern with complete removal of FDI controls is whether foreign direct investors might not be these destabilising entrants that drive forward a process of concentration. FDI entrants are likely to have much bigger advertising and R&D budgets, the latter especially on a global basis, so Sutton's results could be greatly exaggerated. High existing, global expenditure on R&D and/or advertising by a multinational entrant means their level of such expenditure would be inefficiently high for any competitor only involved in the local market. If K is the component of such expenditure which is specific to the new market, the multinational entrant may face an extremely high alpha (given its existing global spend) *even in low alpha industrie*s. This effective escalation parameter of returns of carrying out R&D or advertising for the new market will therefore drive increasing rates of concentration, potentially in all domestic production industries market producing for domestic consumption (non-tradable sector and import-substituting tradables).

Since smaller firms provide much employment, one would expect costs in income poverty at least from this rise in concentration. Moreover, concentration of the corporate tax base may reduce governments' ability to target this sector to generate revenues, exacerbating problems of governments' freedom of distribution and again increasing the tax burden on labour. Concentration in foreign hands when a large proportion of profits are repatriated may do particular damage via this channel. Finally, concentration of wage bargaining power may ultimately work against the growth of real wages.

<p style="text-align:center">*</p>

The linkages between CAL, poverty and inequality through financial markets and industrial structure are numerous, but many point in a similar direction. Two results are of most concern. Firstly, the process of both domestic financial liberalisation and CAL appears likely to be disproportionately hard on smaller firms. Given their

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[15] Where $\alpha = aK^*$ (and where K is chosen such that α is the maximum possible).

importance for employment provision, this could have grave implications for poverty levels. Potentially higher growth led by larger firms (the 'national champions' optimism) may be an unlikely result in economies where the largest firms are dwarfed by foreign competitors. There is also a potential for growing wage inequality between skilled and unskilled workers, and (by a separate argument) those in the traded and non-traded sectors. Moreover, the development of a highly concentrated industrial structure may be damaging for the future allocation of the tax burden, and also for the equity of wage bargaining outcomes. The second area of concern is that of the provision of financial services to the poor, especially the rural poor, which appears deeply unstable after liberalisation. Given the increase in macro-instability and the resultant importance of consumption-smoothing mechanisms for the poor, these services may be withdrawn at a time when they are needed more than ever.

IV. CONCLUSIONS AND SUGGESTIONS FOR POLICY RESEARCH

The key problems of CAL identified here are these. In the channel of government finances:

(i)   the instability of flows (and hence the macroeconomy);

(ii)   the dangers posed by the market 'disciplining' the government; and

(iii)   the costs of managing inflows,

and in the channel of financial market and industrial structure:

(iv)   the volatility of availability of finance to smaller firms and households;

(v)   the possibility of accelerating industrial concentration; and

(vi)   the risk of increasing incidence of tax on labour.

Research directly concerning the poverty impact of macroeconomic policy should therefore address these concerns. A number of proposals are put forward here.

The question of the instability of flows is unlikely ever to be completely solved, but measures to increase the stability of flows and the term horizon of investors can be imagined. One particular policy which has been proposed is that of a fund dedicated to involving institutional investors from industrialised countries more consistently in not only larger MICs but also smaller LICs (and all points between). Specifically, the suggestion is to combine the need for returns and the long-term horizons of pension

funds and life insurance companies in industrialised countries with the need for long-term stable investment of both MIC bond markets and LIC infrastructure policies.

A specific proposal (FitzGerald & Cobham, 2002) recommends the creation of a special purpose vehicle (SPV) to place bonds with institutional investors, managed commercially and with the contribution from development budgets limited to a proportion of subordinated debt. The SPV's portfolio manager would allocate funds between existing bonds and new infrastructure projects in accordance with the risk-return characteristics of each and the market's willingness to bear risk given the extent of underwriting available. Ongoing research indicates that the portfolio efficiency gains from expanded developing country bond holdings would have been substantial for UK institutions, *even for the period covering the US boom and the East Asian (and related) crise*s. Market failures affect the asset allocation of such institutions, and so it is argued that the impact of the SPV – given its viability – would be to generate a learning effect on the market.

The impact of market 'discipline' and the costs of managing inflows are also unlikely to be dispensed with without a complete restriction on flows, but there are many measures to ameliorate the associated problems. One suggestion relies on the externality created by the divergence of social and private costs of capital inflows. The cost of managing flows is borne by government and ultimately society, and creates a fairly constant wedge between private and social cost (although it may rise as the level of flows and bond sales rises and so interest margins too). More variable though is the impact of a build-up of (especially short-term) flows on market sentiment. At higher levels of in-stocks, and given investors' behaviour in times of downturn, reversals with high social costs can result from relatively small new inflows.

One response for governments may be to levy a tax on capital importers in the form of a reserve requirement which varies according to the country's level of in-stocks. Since to seek to make private costs equate to social costs would (a) be to attempt to outguess the market, and (b) involve sudden imposition of very high costs when some level of in-stocks is reached, which could itself be destabilising to the financial system, the preferred alternative is to raise the slope of the private cost function in a more

controlled way. A benefit of this is the build-up of government funds during inflow periods which are ready immediately for release as social expenditure when reversal occurs. Moreover, increasing costs of inflows may prevent the excessive levels which are most likely to provoke crisis.

Only great care, it seems, in the planning of financial liberalisation and privatisation can prevent their having negative impacts on the availability of finance to the poor. Reform and hope for the entrance of NGOs in microfinance should *not* be considered adequate planning. In the area of industrial concentration, the following policy options are put forward. Most simply, with regard to the ability of foreign direct investors (and portfolio investors to an extent) to compete down their tax burdens, perhaps the only real response is to 'be China' – that is, have a sufficiently large market that the opportunity cost of missing out is large for potential investors. A realistic alternative however is the consideration of economic and monetary union. The eurozone has seen significant benefits in (especially non-M&A) inflows of FDI, at the expense of the EMU non-members – the UK in particular. Although such a proposal for (say) southern Africa would be unlikely to produce the same scale of benefits, it would nonetheless improve the bargaining power of states at the expense of corporates. Incentives for the creation of well-functioning markets, systems of corporate governance and legal and regulatory frameworks for bankruptcy etc. would all be increased, and the scale benefits for domestic companies could also be significant. A further benefit would be in the diversification of factors affecting both the current and capital accounts, which should enhance the new currency's stability.

Finally, two suggestions are offered for restricting the possible damage done via increasing industrial concentration. Most simply, the re-introduction of strict controls on the industrial sectors of FDI would allow governments at least some opportunity to restrict entrance into sectors of domestic consumption especially, where the benefits of FDI are less and where the concentration costs may be especially high in foregone employment and increasing wage inequality. Further work on the operation of Sutton's 'bounds' approach in developing countries is also called for. A suggestion with rather more finesse is to focus on advertising in domestic markets. While a high tax on advertising may have some distortionary effects on the development of private media, the overall benefits in terms of restricting industrial concentration may be

more than necessary to justify the measure – employment loss, corporate tax reduction and labour wage bargaining power erosion may all be avoided.

This paper has surveyed the linkages between capital account liberalisation and poverty, and has identified a number of potential mechanisms by which liberalisation can contribute to monetary inequality and undermine government attempts to address other elements of poverty including the provision of health and education. Given the now-broad acceptance that growth benefits have thus far been inconsequential, the implied *net* poverty impact of liberalisation is negative. Further research is still urgently required, but in the immediate short term policymakers should avoid further opening and reflect with an open mind on the possible benefits of well-designed controls. The international financial institutions and developed country governments should take great care not to exert any pressure for ill-considered liberalisation - this includes any attempt to push investment rules that would mandate liberalisation onto the agenda of future WTO negotiations.

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