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Financial Liberalization, Fragility and the Socialization of Risk: Can Capital Controls Work?

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In the wave of neo-liberal economic reform unleashed in developing countries during the 1980s and 1990s, there has been a relatively new and substantial emphasis on the liberalization of financial sector policies. Prior to the 1980s economic liberalisation was primarily concerned with stabilising the balance of payments through contractionary monetary and fiscal policies and structurally adjusting these economies by liberalizing trade and removing controls on domestic capacity creation, production and pricing by domestic and foreign firms. While retaining these features, neo-liberal reform in the 1990s has combined them with a range of policies liberalizing the operations of financial markets and encouraging regulatory forbearance in supervising their operations. Supervision and prudential regulation is intensified in the aftermath of financial failure, only to be diluted subsequently, subject to the adherence to a broad set of guidelines relating to capital adequacy, accounting practices and disclosure norms.

There are three broad effects that the process of financial liberalization has: (i) it opens the country to new forms and larger volumes of international financial flows, in order to attract a part of the substantially increased flows of financial capital to the so-called “emerging markets” since the late-1970s; (ii) to facilitate these inflows it liberalizes to differing degree the terms governing outflows of foreign exchange in the form of current account investment income payments and in the form of capital account transfers for permitted transactions; and (iii) it transforms the structure of the financial sector and the nature and operations of financial firms in a manner that makes the financial system resemble that in countries like the US and the UK.

It is now widely accepted that the first two of these, involving liberalization of controls on inflows and outflows of capital respectively, have resulted in an increase in financial fragility in developing countries, making them prone to periodic financial and currency crises. Analyses of individual instances of crises have tended to conclude that the nature and timing of these crises had much to do with the shift to a more liberal and open financial regime. What is more, crises rarely lead to controls on capital inflows and reduced dependence on them. Rather adjustment strategies emphasise further financial liberalization, resulting in a history of periodic financial failure.

Financial fragility: The early evidence

As early as 1985, Diaz-Alejandro (1985) had detailed why efforts in Latin America in the 1970s to follow the recommendations of the financial repression literature and “free

domestic capital markets from usury laws and other alleged government-induced distortions” had “yielded by 1983 domestic financial sectors characterized by widespread bankruptcies, massive government interventions or nationalization of private institutions (to save financial firms and pre-empt adverse effects), and low domestic savings.”

Prime among the reasons identified was the belief among depositors and financial intermediaries that the government would step in during times of crisis to protect depositors’ savings and prevent closure of financial firms, because of the likely ripple effects such failure would have on the rest of the financial system. This meant that there was no credible threat of bankruptcy, leading to typical moral hazard problems in the financial sector. Domestic depositors and foreign lenders came to believe that the state was offering them a sovereign guarantee, even if that was nowhere explicitly stated. These problems were aggravated by the fact that liberalization was not accompanied by the creation of an adequate supervisory and prudential regulation system worsening these problems substantially. In the event, 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”.

Given this actual experience, it was also true that many of the expected positive outcomes of financial liberalization did not materialize. Rather than encouraging greater competition, there was a strengthening of oligopolistic power through the mergers of financial intermediaries or 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.¹

Further, financial liberalization 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 the Southern Cone experience of the late 1970s and early 1980s suggested that deregulation did not lead to stable interest rates, that interest rates on the whole could remain very high and way above “reasonable estimates of the socially optimal shadow real interest rate.”

Finally, despite short booms in stock markets, there was little mobilization of new capital or capital for new ventures. In fact, small investors tended to withdraw from markets because of allegations of manipulation and fraud, and erstwhile areas of long-term investments supported by state intervention tended to disappear. 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. (Diaz-Alejandro 1985)

On the signs of a new consensus

Though this early evidence was received with some scepticism in many circles, there is now increasing (though sometimes grudging) acceptance of the view that financial liberalization increases financial fragility. It is also seen as not really improving the

¹ In India, nationalisation of the bigger private commercial banks in 1969 was partly motivated by the need to prevent the diversion of household savings to companies linked to the banks or their directors.

growth prospects of developing countries (except indirectly by triggering short-term, credit-financed consumption and housing booms), whereas it works to depress growth and even induce contraction when the accompanying financial fragility leads to a crisis. Recently, it appeared that even the IMF, which has assiduously promoted financial liberalization in developing countries, had come round to the view that such liberalization increases fragility. An IMF Working Paper, authored by Graciela Kaminsky of George Washington University and Sergio Schmukler of the World Bank (2003), authorized for distribution in February 2003 by the IMF's Chief Economist and Research Director Kenneth Rogoff, declares that findings in the "crisis literature" suggest that "booms and busts in financial markets are at the core of currency crises and that these large cycles are triggered by financial deregulation", even though some of "the finance literature tend to support the claim that deregulation is beneficial, with liberalization reducing the cost of capital."

Subsequently, there has been a spate of studies advancing this argument. Thus, an IMF study "Effects of Financial Globalization on Developing Countries: Some Empirical Evidence" (Prasad *et. al* 2003), which includes Kenneth Rogoff among its co-authors, has gone even further. It recognizes: (i) that "an objective reading of the vast research effort to date suggests that there is no strong, robust and uniform support for the theoretical argument that financial globalization per se delivers a higher rate of economic growth; and (ii) that even though (neo-liberal) theory suggests that "the volatility of consumption relative to that of output should go down as the degree of financial integration increases, since the essence of global financial diversification is that a country is able to offload some of its income risk in world markets," in practice "the volatility of consumption growth relative to that of income growth has on average *increased* for the emerging market economies in the 1990s, which was precisely the period of a rapid increase in financial globalization."

This new candour on the part of the IMF has not gone unnoticed. The Financial Times declared that "the new study marks a continued shift within the IMF towards much greater caution in encouraging countries to open up their capital accounts," necessitated in particular by its experience in Argentina and Brazil. One other observer remarked that "The IMF has just abandoned its fatwa against the unmitigated evil of capital controls. Institutional confessions of error don't come much bigger than this one. But while the IMF's many critics are rubbing it in, they shouldn't forget that such a burst of intellectual honesty takes a lot of guts."

The reality regarding the IMF's attitude is, however, entirely different. A close reading of both the working paper and the study referred to earlier indicates that the IMF has decided to accommodate the growing evidence of the adverse consequences of financial liberalization in developing countries, not so much to learn from it and revise its positions but to provide what some are seeing as a more "nuanced" defence of financial liberalization. Kaminsky and Schmukler in fact argue that the problem with existing analyses of financial liberalization is that they separate countries into those that have and those that have not liberalized their financial markets. In actual fact, countries remove different kinds of restrictions at different times, which not merely lead to different degrees and patterns of financial liberalization, but also to "reversal" of the liberalization trend in many contexts.

Once these features of the extent of liberalization of individual markets are taken account of, they argue, the evidence suggests that stock market booms and busts have not intensified in the long run after financial liberalization. The real difference between developed and developing countries is that in the latter, the evidence indicates that in the short run financial liberalization tends to trigger larger cycles, even though it is beneficial in the long run. In mature markets, on the contrary, liberalization appears to be beneficial in the short run as well.

What explains this difference in the case of the developing countries. It is, according to the authors, the fact that institutional reforms aimed at increasing transparency and appropriate regulation of markets do not predate liberalization. It is only after liberalization is adopted as a strategy that governments turn their attention to institutional quality, resulting in the fact that the institutional requirements needed to ensure that liberalization delivers its beneficial effects are put in place only with a lag. This leads to the paradoxical contrast between the short run adverse and long-run beneficial effects of financial liberalization.

The IMF's own study builds on this argument, indicating that the timing and sequence of the release of the two studies may not be coincidental. Taking a more nuanced view of liberalization, as does the Kaminsky-Schmukler paper, the IMF study divides countries into those that are more and less financially liberalized not on the basis of their *de jure* liberalization suggested by their policies, but on the basis of their *de facto* liberalization as indicated by the volume of capital inflows and outflows relative to GDP. Thus, if a country has not adopted liberalization measures to any significant degree, but yet has received large capital inflows, it is treated as a more liberalized financial market. That is, the link between liberalization and capital flows is assumed and not established.

Having classified countries in this manner, the study finds that there is no clearly identifiable effect of financial liberalization on growth in developing countries, and that there is evidence that consumption volatility, in fact, increases with liberalization. However, the study goes on to argue: "Interestingly, a more nuanced look at the data suggests the possible presence of a threshold effect. At low levels of financial integration, an increment in financial integration is associated with an increase in the relative volatility of consumption. However, once the level of financial integration crosses a threshold, the association becomes negative. In other words, for countries that are sufficiently open financially, relative consumption volatility starts to decline. This finding is potentially consistent with the view that international financial integration can help to promote domestic financial sector development, which in turn can help to moderate domestic macroeconomic volatility."

This makes the proliferation of financial and currency crises among developing economies a natural consequence of the "growing pains" associated with financial globalization, and therefore an inevitable stage they have to go through to realize the gains of liberalization. But what cause these short-term crises? The IMF study itself identifies four factors. First, international investors have a tendency to engage in momentum trading and herding, that can be destabilizing. Second, international investors "may" engage in speculative attacks on developing-country currencies, leading to instability that is not warranted by fundamentals. Third, the "contagion" effect that has been repeatedly observed, could result in international investors withdrawing capital from

otherwise healthy countries. Finally, some governments, may not give sufficient weight to the interest of future generations and exploit financial globalization to over-borrow with purely short-term considerations in mind. All of these, needless to say, have a mutually reinforcing effect that exacerbates financial crises when they occur.

It should be obvious that of these the first three have little to do with the behaviour of developing-country governments or financial agents but with the behaviour of financial agents from developed countries. Since developing countries can do little about the latter, the case for pre-empting the effects of such behaviour with financial controls is strong. Yet, having recognized their importance the IMF study goes on to argue that: “The vulnerability of a developing country to the “risk factors” associated with financial globalization is also not independent from the quality of macroeconomic policies and domestic governance. For example, research has demonstrated that an overvalued exchange rate and an overextended domestic lending boom often precede a currency crisis. In addition, lack of transparency has been shown to be associated with more herding behaviour by international investors that can destabilize a developing country’s financial markets. Finally, evidence shows that a high degree of corruption may affect the composition of a country’s capital inflows in a manner that makes it more vulnerable to the risks of speculative attacks and contagion effects.”

Developed industrial countries, the study implicitly suggests, do not have these institutional features that generate the vicious nexus between financial liberalization and short-term volatility, leading to periodic crises. To be like the developed, developing countries have to cross the “threshold”, since the greater financial integration that this requires would automatically lead to improvements in institutional quality as well. So the implication is not that developing countries should give up on financial liberalization but that they should go far enough to ensure that it is accompanied with reform that delivers the institutional quality needed to realize the virtuous relationship between financial liberalization and economic performance.

This is indeed surprising, given the evidence of the factors that led up to the collapse of stock markets in the developed countries, especially the US. That collapse was exacerbated by evidence of conflict of interest (as in the Merrill Lynch case), of market manipulation (Enron) and of accounting fraud (Enron, WorldCom, Xerox), which does not say much for either the transparency or quality of institutions in the US. If it was institutional quality that accounts for the threshold effect, if any such exists, then the instances of successful and failed financial liberalization should not coincide with their categorization as “mature” or “emerging markets”. The only distinction that appears valid is that governments, financial agents and regulatory agencies in mature markets are able to persist with a liberalized financial environment, despite these instances of failure, because there appear to be mechanisms to ensure that such failure does not lead to systemic crises. This is an issue that is taken up later in this paper.

The failure of the studies quoted to take account of these factors points in two directions. First, it suggests that the effort to make a more “nuanced” classification of countries into those that are more and less liberalized countries amounts to manipulating the evidence to yield results that defend liberalization in the long term, even though its consequences are obviously adverse. Second, the new candour is not a reflection of the need to change track, but of the need to ensure that liberalization is persisted with despite the ostensibly

short-run “pains” of the process. The IMF’s case is clear: it does not deny the volatility, the crises and the pain associated with financial liberalization; it merely sees them as the inevitable consequence of the pain that must be suffered to enjoy the long-run benefits of liberalization. The strategy is to assert that evidence that contradicts its case is actually supportive and to focus on prudential regulation rather than capital controls.

The case for capital controls

With the evidence resulting in even this limited ‘agreement’ on the consequences of financial liberalization, there has been a revival of interest in policies aimed at controlling capital flows and reducing the fragility they can result in. There have been two kinds of tension in that literature. The first is between those who emphasise strengthening the domestic financial system and enforcing prudential regulation as a way to retain the benefits of capital flows without suffering from the adverse effects of volatility, and those who argue that the evidence on financial crises is adequate to make “us appropriately wary about statements of the form, ‘we can make free capital flows safe for the world if we do x at the same time,’ where x is the currently fashionable antidote to crisis.” (Rodrik 1998)

The second is between those who believe in the possibility of keeping out the specific forms of capital, such as short term borrowing, that render countries more crisis-prone, and those who argue that this is either not possible or cannot be successfully sustained. Thus, while some made the case for a ‘Tobin tax’ (Eichengreen *at. al.* 1995), others like Davidson (1997) argued that “a ‘grains of sand’ small Tobin tax might slow down the speculative fever when ‘grains of sand’ small exchange rate changes are expected. When dealing with small differentials in exchange rates, however, one is likely to be discussing the question of arbitrage rather than speculation. Accordingly, the Tobin tax is more likely to be a constraint on arbitrage flows rather than speculative flows.” Moreover, while some have positively assessed the efficacy of limited, market-based controls in managing the structure and effects of capital flows, others have been sceptical (Jomo 2002) and seen the shift away from such controls in countries like Chile as being indicative of their unsustainability. Thus, it has been argued: “The evidence on the effectiveness of controls on short-term borrowing is patchy, even in the relatively clean and well-studied case of Chile.” (Rodrik 1998)

It must be noted that, of these measures, while capital controls can, even if not always, conflict with the objectives of advocates of financial liberalization, prudential regulation is very much in keeping with the nature of the shift in regulatory regime that those advocating liberalization want to achieve. In fact, the institutional restructuring that liberalization seeks to achieve, leading to the proliferation of financial agents and instruments and the transformation of the nature of their activities, is to be accompanied by the substitution of direct controls on the operations of firm with prudential regulation relating to capital adequacy, accounting practices and disclosure norms.

However, with the spate of financial crises in recent years, the direction the debate was taking was that of putting strong controls on capital inflows on the agenda. Any recommendation of stringent controls on the nature and extent of capital inflows amounts to arguing that countries must, if at all, stop with liberalizing commodity production and trade, and should not extend the process to the financial sector.

In a sense, the recently growing consensus on the adverse effects on income growth and consumption volatility of financial liberalization and the willingness to search for prudential standards and even some market based controls to reduce these effects is an attempt, in the face of the evidence, to stem the tide in favour of stronger controls on inflows. In fact, much of the literature on the experience with and the prospect of using capital controls takes financial liberalization as a given, and seeks measures that helps policymakers “to promote financial stability, to encourage desirable investment and financing arrangements; to enhance policy autonomy; and to enhance democracy.” (Epstein *et. al.* 2003). This implies some regulation of the nature, maturity and direction of inflows. It also presumes that such regulation would have implications for controls to be imposed on outflows and for the necessary supportive exchange controls.

Post-liberalization controls and policy space

Though such measures can and have reduced excessive volatility in some contexts, the focus on post-liberalization control over capital flows is partially contradictory, especially in countries capable of attracting financial flows. In such contexts, liberalization is adopted in the first instance to attract flows whose presence does affect domestic policy space and autonomy adversely. All financial investors need an exit option, when making investments in particular countries. While there could be some control on inflows in terms of sources (no hedge funds, for example) and maturities (not less than a year without penalties), and some requirements with regard to length of stay and activities may be prescribed, the broad thrust would necessarily have to be in the direction of encouraging flows.

Once such flows occur, policy space is limited for a number of reasons. To start with, the presence of foreign financial investors inevitably introduces a deflationary bias in fiscal policy, independent of the circumstances with regard to supply-side constraints and demand deficiency. Financial interests are against deficit-financed spending by the state for a number of reasons. To start with, deficit financing is seen to increase the liquidity overhang in the system, and 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. Given the consequent dislike of expansionary fiscal policy on the part of financial investors, countries seeking to attract financial flows or satisfy existing financial investors are forced to adopt a deflationary fiscal stance, which limits their policy option.

Further, if a country is successful in attracting financial flows, the consequent tendency for its currency to appreciate, forces the central bank to intervene in currency markets to purchase foreign currency and prevent excessive appreciation. The consequent build-up of foreign currency assets, while initially sterilized through sale of domestic assets, especially government securities, soon reduces the monetary policy flexibility of the central bank. Governments in Asia, especially India, faced with these conditions are

increasingly resorting to trade and capital account liberalization to expend foreign currency and reduce the compulsion on the central bank to keep building foreign reserves. That is, if financial liberalisation is successful, in the first instance, in attracting capital flows, it inevitably triggers further liberalization, including of capital outflows, leading to an increase in financial fragility.²

All this suggests that the use of post-financial liberalization capital control measures can in itself not guarantee adequate monetary and fiscal policy autonomy, and such measures may prove difficult to sustain overtime, as has been the experience in many countries that were cautious when adopting financial liberalization measures.

Financial liberalization and financial structures

But besides these difficulties with the literature focusing on capital controls, it is also characterized by a tendency to ignore the implications of the other aspect of financial liberalization as practiced: namely, the transformation of the structure of the financial system post-liberalization and a consequent increase in the risk of market failure, of the possibility of bankruptcies and closures and even of systemic default.

Financial liberalization, 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. Financial markets are conventionally defined as those that allow inside assets and debt to be originated and traded for each other and for outside financial assets. Often, these assets complement real properties, inasmuch as private agents often borrow to buy real property and pledge the property as security and businesses incur debt to acquire stocks of materials or goods-in-process or to purchase structures and equipments. However, as financial development in the form of *financial deepening* (or an increase in the ratio of financial to material wealth) and greater *financial intermediation* (or the share of financial assets of financial institutions in the value of all financial assets) intensifies, this complementarity is weakened, increasing the autonomy of the financial sector relative to the real sector. This, however, does not mean that developments in the financial sector do not affect the real sector. What occurs is a change in the transmission mechanisms, with the worst effects being observed in periods of financial crises.

In recent years, the increase in financial intermediation and the process of financial deepening have been accelerated by the liberalization of financial sector policies. There are a number of aspects and consequences to such liberalisation as implemented in practice. To start with, it involves reducing or doing away with controls on the interest rates or rates of return charged or earned by financial agents. In practice this never means that the range of interest rates are completely “market determined”. The central bank influences or administers that rate structure through adjustments of the bank or discount rate at which it lends to the banking system and through its own open market operations. The government influences interest rates by altering administered interest rates offered to small savings and pension/provident fund depositors.

² India, for example, has recently permitted its residents to open bank accounts abroad and transfer up to \$25,000 per person per calendar year, which can be used without permission for any current account transaction or for the purchase of financial assets or immovable properties.

While liberalization does not, therefore, fully “free” interest rates, it has other kinds of consequences. It encourages competition between similarly placed financial firms aimed at attracting depositors on the one hand and enticing potential borrowers to take on debt on the other. Competition in these spheres not only takes non-price forms, but leads to price competition that squeezes spreads and forces firms to depend on volumes to shore up their bottom line. That is, within the range implicitly set by the central bank (and at times the government) banks can be encouraged by liberalization of rates to accept lower spreads in the hope of neutralising the effects on profits by attracting larger volumes of business.³

The second feature of financial liberalization is that it removes or dilutes controls on the entry of new financial firms, subject to their meeting pre-specified norms with regard to their capital base. This aspect of liberalization inevitably applies to both domestic and foreign financial firms, and caps on equity that can be held by foreign investors in domestic financial firms are gradually raised and done away with. Easier conditions of entry do not automatically increase competition in the conventional sense, since liberalization also involves freedom to acquire financial firms for domestic and foreign players and extends to permissions provided to foreign institutional investors, pension funds and hedge funds to invest in equity and debt markets. This often triggers a process of consolidation.

Thirdly, liberalization involves a reduction in controls over the investments that can be undertaken by financial agents. This can take two forms. Financial agents could be permitted to invest in areas they were not permitted to enter earlier. Most regulated financial systems sought to keep separate the different segments of the financial sector such as banking, merchant banking, the mutual fund business and insurance. Agents in one segment were not permitted to invest in another for fear of conflicts of interest that could affect business practices adversely. Financial liberalization involves the breaking down of the regulatory walls separating these sectors, leading in the final analysis to the emergence of the so-called “universal banks” or financial supermarkets. The consequent ability of financial agents to straddle multiple financial activities implies that the linkages between different financial markets tend to increase, with developments in any one market affecting others to a far greater degree than they did before.

Fourth, liberalization involves the expansion of the sources from and instruments through which firms or financial agents can access funds. This not only leads to the proliferation of instruments such as commercial paper and certificates of deposit issued in the domestic market, but instruments like ADRs or GDRs issued in the international market.

Fifth, the expansion of sources of funds is accompanied by the liberalization of the rules governing the kinds of financial instruments that can be issued and acquired in the system. Financial instruments allow agents to share to differing degrees financial gains and risks, where the gains involved are incomes and asset price appreciation and the risks are, therefore, income and capital risks. These assets can either be issued directly by those looking for capital for productive investments or by intermediaries expecting to

³ Non-price competition can also result in a reduction in spreads since it may involve higher costs in the form, for example, of larger investments in a wider Automatic Teller Machine (ATM) network or higher labour costs to provide “relationship banking” services to high value clients.

obtain a part of the incomes in return for carrying part of the risk. In most instances, the proliferation of financial assets that liberalization involves transforms the traditional role of the banking system of being the principal intermediary bearing risks in the system. Banks performed their traditional role by accepting relatively small individual liabilities of short maturities that were highly liquid and involved lower income and capital risk and made large, relatively illiquid and risky investments of longer maturities. The protection afforded to the banking system and strong regulatory constraints on it were meant to protect its viability given the role it played.

The way that role is transformed is captured, for example, in the following description of the bank in today's more liberalised financial system: "There was a time when a bank would lend to a business or provide a mortgage, would take the asset and put it on their books much the way a museum would place a piece of art on the wall or under glass – to be admired and valued for its security and constant return. Times have changed. Banks now take those assets, structure them into pools, and sell securities based on those pools to institutional investors and portfolio managers. In effect, they use their balance sheets not as museums, but as parking lots – temporary holding spaces to bundle up assets and sell them to those investors who have a far greater interest in holding those assets for the long term. The bank has thus gone from being a museum where it acquired only the finest assets and held and exhibited them in perpetuity into a manufacturing plant which provides a product for the secondary market. Just as Henry Ford did 80 years ago, banks today are focusing on producing a standardised product at a predictable rate, under standard norms of quality, and are teaching their workforces to produce that product as quickly and as efficiently as possible." (OECD, 2000). Thus, liberalization triggers a shift in the role of the "pure" banking system as the principal bearer of financial risk to one where its focus is that of generating financial assets that transfer risks to the portfolio of institutions willing to hold them.

Sixth, in keeping with the requirements generated by liberalization of capital flows, there is a substantial degree of liberalization of the exchange control regime, with the full convertibility for current account transactions accompanying trade liberalization being complemented with varying degrees of convertibility on the capital account.

Seventh, in many contexts liberalization involves the withdrawal of the state from the activity of financial intermediation with the conversion of the "development banks" into regular banks and the privatization of the publicly owned banking system, on the grounds that their presence is not conducive to the dominance of market signals in the allocation of capital. In India, for example, all three major development financial institutions (the Industrial Finance Corporation of India, the Industrial Development Bank of India and the Industrial Credit and Investment Corporation of India) have been or are being dismantled, converted into multi-purpose banks and privatised.

Eighth, financial liberalization eases conditions for the participation of both firms and investors in the stock market by diluting or doing away with listing conditions, by providing freedom in pricing of new issues, by permitting greater freedoms to intermediaries such as brokers and by relaxing conditions with regard to borrowing against shares and investing borrowed funds in the market. In addition, conditions relating to the need to declare share acquisitions that can lead to takeovers are also relaxed.

Finally, rather than resort to regulation through direct intervention, liberalization involves the shift to a regime of voluntary adherence to statutory guidelines with regard to capital adequacy, accounting norms and related practices, with the central banks role being that of supervision and monitoring.

Homogenisation of financial sectors

Clearly, liberalization of this kind not only results in changes in the mode of functioning and regulation of the financial sector, but a process of institutional change. It inevitably involves the reshaping of relatively “immature” financial systems in developing countries in the image of the increasingly ‘market-based’ systems characteristic of the developed capitalist world, especially the US. There are a number of implications of this process of institutional change. First, it implies that the role played by the pre-existing financial structure in developing countries, characterised by the presence of state-owned financial institutions and banks, is substantially altered. In particular, the practice of directing credit to specific sectors at differential interest rates is undermined by reduction in the degree of pre-emption of credit through imposition of sectoral targets and by the use of state banking and development banking institutions as instruments for mobilising savings and directing credit to priority sectors at low real interest rates. The role of the financial system as an instrument for allocating credit and redistributing assets and incomes is also thereby undermined.

Second, by institutionally linking different segments of financial markets by permitting the emergence of universal banks or financial supermarkets of the kind referred to above, the liberalization process increases the degree of entanglement of different agents within the financial system and increases the impact of financial failure in units in any one segment of the financial system on agents elsewhere in the system.

Third, by allowing for the proliferation of financial institutions and instruments it not merely increases liquidity in the system but it also allows for an increase in the practice of risk transfer through processes such as securitization, especially credit risk transfer by banks. For example, in India, which has recently introduced interest rate futures, Citigroup has concluded three securitization deals worth Rs. 570 crore (\$126.6 billion), where yields on government securities or the call money rate, are used as the benchmark for pricing floating rate payments for investors in these derivatives.⁴ The underlying receivables arise from a large number of fixed rate loan contracts made for financing commercial vehicles and construction equipment. The risk here is being shared with mutual funds, who are reportedly the major investors.

Fourth, it allows for a process of segment-wise and systemic consolidation of the financial system, with the emergence of larger financial units and a growing role for foreign firms in the domestic financial market. This does mean that the implications of failure of individual financial agents for the rest of the financial system is so large that the government is forced to intervene when wrong judgments or financial malpractice results in the threat of closure of financial firms.

Institutional change and financial fragility

⁴ Joshi, Anurag, “Citigroup securities deal benchmarking g-sec yield”, **The Economic Times**, New Delhi, Friday 6 February 2004.

The above package of financial liberalization policies is often presented as a process of infusing competition into the financial sector and increasing the flexibility of individual institutions to respond to that competition. This changed competitive scenario is expected to lead to a greater degree of “efficiency” of the financial sector, resulting in a better allocation of investible resources, between alternative investment options.

One problem with this perception is that it privileges questions of allocative efficiency relative to those concerned with the factors determining the size of aggregate investment itself, especially in situations where resources are unemployed. In fact, investment increases in this perception because it erroneously expects increased efficiency to release “surplus” resources that in pre-Keynesian fashion would be automatically reinvested, leading to higher growth. In doing this, critics of financial liberalization argue, it reduces the investment and growth potential of the system, relative to what would prevail within a more interventionist regime.

The more serious difficulty is that it fails to take account of the fact that the practice of rendering the financial structure more competitive through liberalization involves institutional changes that unleash a dynamic that endows the financial system with a poorly regulated, oligopolistic structure, which could increase the fragility of the system. Greater freedom to invest, including in sensitive sectors such as real estate and stock markets, ability to increase exposure to particular sectors and individual clients and increased regulatory forbearance all lead to increased instances of financial failure. In addition, by institutionally linking different segments of financial markets by permitting the emergence of universal banks or financial supermarkets, the liberalisation process increases the degree of entanglement of different agents within the financial system and increases the impact of financial failure in units in any one segment of the financial system on agents elsewhere in the system. Such possibilities are all the greater because liberalization implies a degree of regulatory forbearance of the kind described earlier.

Financial markets left to themselves are known to be prone to failure because of the public goods characteristics of information which agents must acquire and process (Stiglitz 1993, Rodrik 1998). They are characterised by insufficient monitoring by market participants. Individual shareholders tend to 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 investments, leading to what has been observed as the “herd instinct” characteristic of financial players. This not merely limits access to finance for some agents, but could lead to overlending to some entities, 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, as happened in Japan in the late 1980s and East Asia in the late 1990s. Loans to these sectors can be at extremely high interest rates because the returns in these sectors

are extremely volatile and can touch extremely high levels. Since banks accept real estate or securities as collateral, borrowing to finance speculative investments in stock or real estate can spiral. This type of activity thrives because of the belief that losses if any can be transferred to the lender through default, and lenders are confident of government support in case of a crisis. This could feed a speculative spiral that can in time lead to a collapse of the bubble and bank failures.

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.

The point is that while financial liberalization leads to these kinds of risks, the evidence suggests that the expected microeconomic gains are not really realised. Even in the US, the role of stock markets as a source of capital was limited. Between 1970 and 1989, the ratio of profit retention, bank finance and bonds to the net sources of finance of non-financial corporations in the US amounted to 91.3, 16.6 and 17.1 per cent respectively. The contribution of equity was a negative 8.8 per cent. The first two of these sources played an overwhelming role even in the U.K. and Germany during this period. (Stiglitz 1993). Thus bond markets play a limited role and equity markets virtually no role at all in financing corporate investment in these countries. The stock market is primarily a site to exchange risks rather than raise capital for investment. In developing countries too the new issues market is small or non-existent except in periods of a speculative boom, and bank lending post-liberalisation privileges risky high-return investment rather than investment in the commodity producing sectors like manufacturing and agriculture. The effects on those sectors of liberalisation is indirect, being realised through the demand generating effects of housing and personal finance booms, which too in many circumstances tends to increase the fragility of the system.

The capital inflow effects of financial liberalization only aggravate these consequences of the institutional change component of the process. It does not just increase liquidity and permit access to funds that can be played with, it brings in players more adept at dealing with the opportunities offered by the new financial context. When the potential of financial failure becomes or threatens to become a reality, the funds dry up and capital flight occurs, increasing the intensity of the ensuing crisis. Capital controls seen as measures to control the volume and volatility of cross-border capital flows in a liberalized financial system, even if successful, do not deal with the essential fragility of the system. It can at most alleviate the intensity of crises.

Implications for the real economy

The institutional change associated with financial liberalization not merely increases financial fragility. It also dismantles financial structures that are crucial for economic growth. 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 channelizing 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 growth and 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 scales of production, but also 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) channelizing 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 industrializers 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.

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

Explaining financial liberalization

The question then is why developing countries have in recent years been opting for more liberalized financial regimes? Very often the onset of financial liberalization is explained as being the result of developing countries seeking to attract foreign capital inflows into their economies. The expansion of liquidity in the international financial system after the mid-1970s, it is argued, provided developing countries with new opportunities. To exploit those opportunities developing countries resorted to financial liberalization and in the process corrected the repression that their financial sectors had been subjected to for decades.

While this is indeed partially true, the difficulty here is that the volume of capital flows into a country is not necessarily related to the extent of liberalization of its financial sectors, as the Chinese experience indicates. Further, most often financial liberalization is adopted as part of the adjustment necessitated by balance of payments problems generated by an initial flow of foreign capital, as was true in some Latin American countries after the debt crisis of the 1980s. Though there is a “chicken-or-egg” problem associated with identifying whether financial liberalization precedes enhanced capital flows or not, there is reason to believe that a unidirectional causality from liberalization to enhanced capital flows does not stand up to scrutiny. Given this, when developing countries opt for financial liberalization that increases fragility, only based on the hope that it may help draw large capital inflows, they must be compelled just by some perceived rationale of the process but also by circumstances, internal and external that make this the preferred, though risky, option.

In the circumstance a useful route to follow is to enquire whether the process of homogenizing financial structures is driven primarily by the financial interests in countries that were the original home of the increasingly ubiquitous Anglo-Saxon model. Post-liberalization changes in the institutional structure of the financial system in the developing countries do benefit foreign financial firms substantially. Liberalization allows for a process of segment-wise and systemic consolidation of the financial system, with the emergence of larger financial units and a growing role for foreign firms in the domestic financial market. It also allows for a greater role for foreign institutional investors in local equity and debt markets, a substantial increase in speculative activities and often a wave of capital inflow that renders exchange rate and monetary management extremely difficult. These investors are, when the going is good, able to earn much higher

rates of return stemming from the premia associated with an engineered notion of risk, which far exceeds the exchange rate risk characterising many of these economies. Further, when exchange rates do tend to fluctuate, the new options for trading in currency markets generated by liberalization, offers an additional channel of profit. And above all, the risks to be borne in these markets are doubly insured against. First, there is the near certainty of intervention by developed country governments and the Bretton Woods institutions that ensure that there are orderly workouts in times of crisis.⁵ Second, financial liberalization offers opportunities not just to hedge against risk but to transfer and socialize those risks through securitization measures that generate new assets that help transfer credit and other financial risks by banks and non-bank financial institutions.

These gains registered by international financial institutions, particularly those from the United States are merely inflated versions of the gains that the institutions have derived from liberalization in their own home countries. A study of the US experience with so-called financial innovation and liberalization points in two directions. First, the Anglo-Saxon model of an ostensibly “efficient” financial system is of relatively recent origin even in the US. Second, this model evolved principally as a way of protecting and enhancing the profits and ensuring the viability of financial firms whose clout has increased substantially in the age of finance – a feature which has implications for its adoption by developing countries.

THE EVOLUTION OF THE ANGLO-SAXON MODEL

The financial system which developing countries are increasingly treating as the image of their own future regimes is the result of “innovations” that are quite recent. As is well known, till the late 1970s the US financial system was highly regulated. Regulation was necessitated by the spate of bank failures that characterised the early 20th century. Prior to the 1930s, a regime of free banking prevailed in the US. Fears of centralization in a country that was strongly federal and a healthy distrust of monopoly encouraged every region and area to foster at least one bank as a sign of financial independence and then promote more banks to encourage competition.

The interest rate competition this unleashed to attract deposits and the consequent tendency to invest in risky, high-return areas soon showed up in a high degree of financial fragility. Bank closure was routine and depositors periodically suffered losses. Soon regulation was resorted to in order to limit that fragility. Regulation at that time had two stated objectives. One was to protect bank customers against malpractice and fraud. The second was to partially insulate the financial system from bank runs and failures. There were local and national laws enacted to limit deposit and loan interest rates, restrict entry and branching expansion, set geographical and line-of-business boundaries, and establish prudential standards and monitoring procedures that, whatever their main purpose, also restrained competition in lending. But despite these strenuous efforts, hundreds of banks were failing annually as late as the 1920s.

Things worsened over time. During 1930-32, 5096 commercial banks located in the US, about 20 per cent of the mid-1929 total, suspended operations, and most subsequently failed. In response, the government of President Roosevelt introduced the Banking Act of

⁵ The most recent, even if unsuccessful, effort of the IMF to ensure such orderly workouts, is the promotion of the Sovereign Debt Restructuring Mechanism (SDRM).

1933 (the Glass-Steagall Act), which imposed a strong regulatory framework that developed to have five dimensions. First, it created the Federal Deposit Insurance Corporation (FDIC) for federal insurance of deposits. From the point of view of the small depositor, all banks became identical and completely secure, regardless of their balance sheets. Second, it set limitations on interest payments on deposits. Interest was prohibited for demand deposits and ceilings on rates introduced for time and savings deposits. These price controls were implemented through Regulation Q. Because of these controls, the principal financial intermediaries could not attract depositors by paying higher interest rates, so that there was no direct imperative to invest in assets offering high returns that are also risky and prone to default. Third, together with the McFadden-Pepper Act of 1927, Glass-Steagall provided for entry barriers that limited 'excessive' competition among banks. Foremost it reinforced the individual states' authority to restrict inter-state banking and limit bank holding companies and other instruments of concentration. Fourth, the operations of banks were restricted. There were restrictions on investments that banks could make, which were principally limited to provision of loans and purchases of government securities. There were also prohibitions with regard to the kinds of activities that banks or their affiliates could indulge in, with a ban on underwriting securities and serving as an insurance underwriter or agency, and commercial activities. The restrictions also included a 10 per cent limit on outstanding exposure to a single borrower and limits lending to sensitive sectors like real estate.⁶ This was clearly aimed at ensuring that the moral hazard associated with deposit insurance did not lead to risky investments and pre-empting the practice of financing losses elsewhere in the financial sector with bank equity. Finally, a system of regulating solvency was put in place, involving periodic examination of bank financial records and informal guidelines relating to the ratio of shareholder capital to total assets.

It should be clear that the regulatory framework made banks the principal carriers of credit risk, limited the risk exposure of the banking system and protected bank profitability by keeping deposit rates below market interest rates and reducing the probability of bank runs. The profits of the principal financial agents of the time were being protected. These restrictions were in force for around 35 years, during which the US economy witnessed its post-war boom without experiencing the financial fragility that has come to characterise the system in recent years.

The point to note is that right through the period of intensive regulation of the financial sector in the US, there was little financial "innovation" in terms of new instruments or institutions, though there were periods characterized by substantial and rapid growth in the financial sector. In the event, even by the 1950s, banks and banking activity constituted 80-90 per cent of that in the financial sector. Even at the end of the 1950s, savings accumulated in pension and mutual funds were small and trading on the New York Stock Exchange involved a daily average of three million shares at its peak. This was to rise to as much 160 million shares per day during the second half of the 1980s (1986-91). (Sametz 1992).

The restructuring of US finance

⁶ Real estate loans secured by first liens could not exceed total savings deposits of a bank or, if greater, its unimpaired paid-up capital and surplus.

The process of restructuring of US finance, which replaced this regulated regime with the much more diverse and market-based system that characterizes it now, was driven in the first instance by factors internal to the US economy. Financial liberalisation policies that ensured such restructuring were the result of efforts to deal with factors that at different points were adversely affecting the level of financial activity and the profitability of financial firms.

The first changes to the now ostensibly “archaic” system came not because it could not support the post-war boom, but because the end of the boom challenged its viability. With unemployment rates low and wage rates rising, inflation could be kept in check if productivity rose faster than wages and primary-commodity price increases were moderate or nil. By the late 1960s the US was finding it difficult to ensure the first of these conditions resulting in domestic inflation and a loss of international competitiveness. Between 1965 and 1972 consumer prices rose by over four percent per annum, which was double the previous average rate during peacetime for most of the century till then. In response the government adopted a restrictive monetary policy that raised interest rates on government securities. The Federal Reserve which had kept Treasury bill rates at 1.5-3 per cent and bond rates at 2.5-4 per cent for long altered its policy leading to a doubling of interest rates, with the prime rate averaging 6.5 per cent during 1965-72.

Since the interest rates on time/savings deposits was fixed at three per cent and no interest was to be paid on demand deposits, savers faced negative interest rates, leading to demands for new instruments. Soon alternative instruments in the form of Treasury bills for large savings accounts holders, certificates of deposit, money market mutual funds (that permitted small savers entry into the Treasury bills market) and life policies were being offered by the financial services industry. Thus the first wave of financial innovation was the result of the inability of the US state to maintain price conditions that rendered the earlier interventionist regime sustainable.

In the event, with market interest rates rising above the Regulation Q ceiling by the late 1960s, a process of disintermediation began, with funds from the banks leaking out to securities markets. Banks themselves responded to the new situation by finding ways to circumvent regulatory constraints. They formed holding companies that issued commercial paper or tapped funds from the Eurodollar market, which were then passed on to banking subsidiaries for onlending. But this obviously meant that bank investments must yield higher returns. Soon regulators were exempting large dollar deposits from Regulation Q to help the banking system retain or attract funds.

But all this proved insufficient when the oil shocks of the early and late 1970s aggravated the inflation problem, undermining the second requirement for price stability. The severely restrictive monetary policy adopted by the Federal Reserve in the new circumstances took interest rates to new highs, from 5 per cent short term and 6 per cent long term during 1966-72 to 8 and 9.5 respectively during 1973-82. This triggered a new wave of disintermediation, with depositors moving their savings into money market funds (MMFs). In response, Congress enacted in March 1980 a law implementing a six-year phase out of Regulation Q. But this was no remedy. Between March 1980 and December 1982, the balances in MMFs rose from \$61 billion to \$230 billion. Not surprisingly,

depositories were authorised to offer unregulated accounts that were insured, heralding the end of the era of regulated interest rates.

Once the specific response to the late-1960s and post-1960s crisis facing the US economy triggered the phase out of the regulated interest rate regime, a change in the institutional structure of the financial sector was inevitable. With money market funds gaining in importance and accumulating capital to be invested an increase in stock market activity was inevitable. Further, accompanying the rise in rates was a high degree of volatility with the range between highs and lows widening from 4 to up to even 14 per cent. Similarly, while the contraction implied that stock prices rose only by 12 per cent over the period as a whole, year-to-year variability varied between plus and minus 20 per cent. This encouraged the creation of new instruments to hedge against the risks associated with such volatility, triggering the process of securitization. This included forms of early futures and options on financial assets. Examples were futures contracts on interest rates on Treasury bills and bonds. The pension and mutual fund institutions that had grown in the interim invested heavily in these instruments leading to a flourishing market.

Policy to save the banking industry involved not just deregulation of deposit rate ceilings, but also new banking instruments such as variable rate mortgages and floating rate notes, so that flexibility in deposit rates could be matched with flexibility in lending rates. Banks began using the securities markets to obtain funds and invest in commercial paper. The trend to securitization intensified with instruments such as pass-through mortgage bonds.

The process of innovation triggered by the developments during the years of the oil shocks was accelerated by the stock market boom of 1983-87, when stock prices doubled. The boom provided the spur for new forms of hedging aimed at protecting the massive gains that were registered in financial markets. Options of various kinds and stock index futures were in demand. Increased liquidity encouraged the trend of leveraged buyouts, which were debt (junk bond)-funded acquisitions by financial entities of firms through purchase of stock, with the aim of future sale for a profit.

With banks now having to cover the much higher interest rates they were paying on deposits, they had to have new avenues for investment. They saw their viability being dependent on entering non-bank businesses where profits were high. This included investment in LBOs (junk bonds), real estate development loans and bridge loans, and purchasing equity positions in businesses. Even though the risks involved were high and the requisite skills different, banks were not afraid of entering these areas so long as the \$100,000 per deposit coverage of deposit insurance remained in place. Thus the pressure to liberalize banking regulation was high.

This paved the way for the removal of restrictions on banking activity. Not surprisingly, it was in 1982 that the process of dismantling of the Chinese Walls separating different segments of the financial sector began. In that year, the Office of the Comptroller of Currency permitted several banks to set up subsidiaries to engage in the discount brokerage business. Soon mergers to encourage such activity were permitted. In 1983, the then second largest US bank holding company was allowed to acquire the largest US discount brokerage company. Since then the process has continued. Bank holding companies (which was the superficial form adopted by US banks seeking expansion)

were allowed to extend their underwriting activities, starting with the underwriting of third-party commercial paper through securities subsidiaries and extending subsequently to municipal revenue bonds, mortgage-backed securities, securities backed by consumer loans, and, finally corporate bonds and equities. All of these substantially enlarged the area of activity of the banks.⁷ The net result of these developments was a decline in the role of the banking business within financial markets.⁸

Banks soon started generating new arrangements and instruments such as SWAPs and 'synthetic' securities. The latter process involves bundling parts of the underlying financial instruments, negotiating the exchange between two parties of, say, flexible and fixed return flows and guaranteeing the contract. Such "synthetic securities" are outside the new regulatory framework that retains few restrictions on banks' securities activities, such as underwriting banks' securities for public distribution.

Finally, to increase the flexibility that banks had in making investments, the federal and state governments deregulated bank solvency protection measures. The most disastrous change was in the regulations governing the savings and loan industry. Here, formal capital standards were lowered, the intensity of supervision was relaxed and accounting rules 'simplified'. This kind of regulatory 'forbearance', kept open a large number of insolvent institutions and allowed them to make speculative investments with federally insured deposits.

Though not to the same degree, regulatory forbearance was practiced vis-à-vis the banking industry as well. Thus, large banks with huge exposures in developing country markets were not required to write off those loans, or establish loss reserves on them at market levels. This allowed these banks to declare higher than warranted profits and even pay out excessive dividends. Further, bank regulators were lax when it came to shutting down or forcing the merger of 'problem' banks allowing them to speculate to recover their positions, often with disastrous consequences.

Overtime, with the lines separating the banking and securities business blurring, regulatory measures similar to that governing the securities business came to be applied to the banking industry. Investment banking regulation, implemented by the Securities and Exchange Commission involves compulsory "full" disclosure of information on new and outstanding securities, fair trading in securities and future/option markets, mark-to-market accounting rules and risk-adjusted capital requirements. On the other hand, there are neither prohibited securities nor any limits to geographic location. Since the banks too

⁷ Another means was the strange innovation called 'non-bank banks', or depositories that were permitted to offer consumer, but not commercial, loans and were free to be associated with a broad range of financial and non-financial activities. However, shocked by the crises in several banks and thrift institutions the Congress in 1987 instituted a moratorium on new 'nonbank banks' and substantially curtailed the growth of existing ones.

⁸ There were "innovations" in other areas as well. The Garn-St. Germain Depository Institutions Act of 1982 raised the one-borrower exposure limit to 15 per cent, which could go up to 25 per cent in the case of borrowers offering a sufficient dollar amount of readily marketable collateral. The act also abolished limits on the total of outstanding first-lien real estate loans. Further, geographic restrictions on banking were substantially diluted, and by the early 1990s, almost all states had enacted some kind of interstate banking law and over 30 allowed entry by bank holding companies located anywhere in the country.

were provided similar built-in freedoms, regulatory guidelines too came to resemble those in the securities industry.

Thus, by adopting a range of measures, the US state and federal governments and the Federal Reserve dismantled during the 1980s the system of regulation and the financial structure created by the policy framework put in place during and after the Great Depression.

The impact of this process of deregulation was immediate and obvious. It resulted in a dramatic increase in the rates of failure of banks and thrift institutions and strained the deposit insurance system. During 1955-81, failures of US banks averaged 5.3 per year, excluding banks kept from going under by official open-bank assistance. On the other hand during 1982-90 failures averaged 131.4 per year or 25 times as many as 1955-81. During the four years ending 1990 failures averaged 187.3 per year. The most spectacular set of failures, was that associated with the savings and loan crisis.

Financial liberalization and the socialization of risk

In the first instance, the impact of these failures on the rest of the financial system was minimized through a process of using the various deposit insurance corporations (FDIC and FSLIC) to protect depositors or through direct government largesse. At the end of the 1980s, the S&L crisis was officially estimated to have cost at least \$90 billion in tax payers' money. Subsequently, that figure was revised upwards to as much as \$200 billion. Though bank failure costs were lower, they too depleted the reserves of the FDIC and by the early 1990s that institution was considered insolvent. The costs of the deregulatory response to the banking crisis starting in the late 1960s were high, when seen in terms of financial instability and mortality. But the system of deposit insurance that was ostensibly aimed at protecting customers was actually being socialised by placing the burden on the tax payer.

It should be clear that this process of socialization of risk and the burden of failure through deposit insurance or direct government largesse could not be sustained. This is why the process of securitization and the transfer of risk that the process facilitates has become extremely important. As **The Economist**⁹ recently put it: "The world's leading banks decided some years ago that lending is a mugs' game. They began to get rid of their loans, repackaging them and selling them off as securities, or getting others to re-insure their risk." From the point of view of the banks this effort has been extremely fruitful. Thus, recently when there was a major melt down in corporate America, as a result of financial fraud and accounting malpractice, leading to the closure of giants like Enron and WorldCom, leading banks that had lent large sums to them appeared unaffected. According to one estimate, loans totalling \$34 billion were wiped out through these bankruptcies. But far less amounts showed up as losses in the bank's accounts and, in the second quarter of 2003, Citigroup reported a 12 per cent increase in profits and J.P. Morgan Chase a 78 per cent increase.

It should be clear that these losses have to show up somewhere in the accounts of the financial system, but as the Bank of International Settlements (2001 and 2003) recently argued, it's not easy to trace them. One reason could be that these losses were being borne

⁹ "Credit risk transfer: Gone too far" and "Who's carrying the can", **The Economist**, August 14 2003, London.

by insurance companies, which would be treating them like any other casualty loss so that they are not identifiable. The BIS sees this conundrum as being the result of the substantial growth of the practice of credit-risk transfer—the shifting of risk from banks on to the buyers of securities and loans, and on to the sellers of credit insurance.

This tendency to transfer credit-risk is aggravated by the fact that returns on loans are well below the 15 per cent return banks are reportedly expecting these days. As a result, most banks are striving hard to get loans off their own books. Thus, over two-and-a-half years starting in early 2001, Deutsche Bank reportedly reduced loans in its books from \$264 billion to \$187 billion. Other banks too seem to have adopted this practice of reducing recorded loans in 2002: ABN Amro by euro34 billion, Credit Suisse by SFr12 billion (\$8.6 billion), and UBS by SFr10 billion. Overall, in the early 1990s, such transfer involved a few billion dollars-worth of loans; by 2002, that figure had grown to more than \$2 trillion. “The markets lack transparency about the ultimate distribution of credit risks,” The BIS wrote. “Some market participants may take on more risk than others...or the authorities, are aware of.”

There can be no doubt that this was a continuation of the process of using the “hedging against risk” slogan in the 1980s to socialize risks. At that time American banks started to bundle together mortgages and issued securities backed by them which were sold to the less financially savvy. After mortgages came various kinds of consumer credit: credit-card receivables, car loans, commercial property loans and so on. The intention – of converting the bank from a ‘museum’ to a ‘parking lot’ - was to make more profit from generating such business (and the fees associated with it) than could be made by holding on to the loans until they matured. Thus: “the traditional image of the great banking hall and the armoured vaults stuffed with bullion has little to do with the way banks make their money. These days they make loans and then pass them on as quickly as possible, pocketing the margin. That leaves them more room to take bigger risks elsewhere: in trading securities, derivatives, and foreign exchange, for example, or investing in private equity.” The shift of credit risk to non-bank entities does seem to saddle them with a disproportionate share of doubtful debt. Thus, at the end of 2002, though non-bank entities accounted for just 10 percent of the syndicated loan market in the US, they held 22.6 per cent of the bad or doubtful loans.

The other way in which banks are getting credit risk off their balance sheets is through the business of credit derivatives. A buyer of a credit derivative buys insurance relating to a single company, from a seller. If the company defaults, the seller of the protection makes good the loss. Credit derivatives too began in a small way in the mid-1990s. By 2000, there was \$800 billion-worth outstanding, and by 2002 the total was close to \$2 trillion. That means there is credit insurance outstanding on a notional \$2 trillion-worth of bonds and loans. The derivatives bought and sold can exceed the credits outstanding. Nevertheless, those who have bought the insurance have \$2 trillion of protection—which might mean that there are plenty of firms in the financial markets, with net long positions, who are either indifferent to, or even eager for, the default of particular borrowers.

A survey by credit-rating agency Fitch of 150 participants in the credit-derivatives market and found that banks in the United States and Europe are net buyers of credit protection, to the tune of nearly \$190 billion; insurance companies and other financial organisations are net sellers, to the tune of \$300 billion”

Thus, the Economist noted echoing the BIS, “the risk, and the losses that inevitably flow from it, may be being redistributed to entities that are less well capitalised and less expert in analysing borrowers than banks. Moreover, they may be feeding through to places where they could eventually be socially and politically painful—for example, to pension funds, mutual funds, or life-insurance policies.”

EXTERNAL SPREAD THROUGH FINANCIAL LIBERALIZATION

Given this internally generated process of evolution of the financial system in the developed industrial countries, that was reflective of processes designed to deal with the fragility that reduced regulation implied, it should be expected that any increase in presence of agents from within that system in new markets would require in time the replication of the metropolitan system in these new markets. In practice, changes that were occurring both within the developed countries and outside, especially the latter, was forcing financial firms in the developed world to seek out new markets in developing countries. This paved the way for demands to homogenise financial structures in developed and developing countries.

Till the early 1970s the private international financial system played only a limited role in recycling financial surpluses to the developing countries. The period immediately after the first oil shock saw a dramatic change in this scenario. Since oil surpluses were held in the main as deposits with the international banking system controlled in the developed world, the private financial system there became the powerful agent for recycling surpluses. This power was indeed immense. Expenditure fuelled by credit in the developed and developing world generated surpluses with the oil producers, who then deposited these surpluses with the transnational banks, who, in turn, could offer further doses of credit. By 1981, OPEC countries are estimated to have accumulated surpluses to the tune of \$475 billion, \$400 billion of which was parked in the developed industrial nations. This power to the finance elbow was all the more significant because a slow down in productivity growth in metropolitan industry had already been bringing the post-War industrial boom to a close - a process that was hastened by the contractionary response to the oil shocks. The consequence was the burgeoning of the market for international finance.

Two other developments contributed to the increase in international liquidity during the 1970s and 1980s. First, the United States had built up large international liabilities during the Bretton Woods years, including those resulting from expenditures on the Vietnam War and its policing efforts elsewhere in the world. The explosion of the Eurocurrency market in the 1970s reflected this. This was sustained by the confidence in the dollar stemming from the immediate post-War hegemony of the US, which made it as good as gold. Such international confidence in its currency allowed the US to ignore national budget constraints on its international spending and resulted in the emergence of strong banking and financial interests with an international agenda. The influence of these interests was reflected in policies that affected domestic manufacturing interests adversely, as suggested by the widening and persistent US trade deficit after the mid-1970s.

Second, the loss of manufacturing competitiveness in the US meant that the dollar lost its position as the only acceptable reserve currency. Given the accumulation of dollar surpluses in world markets, this challenge to the dollar resulted in growing demands on

the US to redeem its pledge to exchange dollars for gold on demand. Responding to this the US government chose to suspend the Smithsonian Agreement, leading to the break down of the Bretton Woods system of fixed exchange rates and heralding the era of floating exchange rates.

This resulted in greater trading of currencies, including for speculative purposes, and in the need for those with foreign exchange commitments and those expecting foreign exchange receipts in different currencies to hedge against exchange rate risks. The speculative demand for currencies, needless to say, is sensitive to both interest rate differentials and exchange rate variations, resulting in volatile flows of capital across currencies and borders. The results of these developments were obvious. The daily volume of foreign exchange transactions in international financial markets rose to \$1.2 trillion per day by the mid-1990s, which was equal to the value of world trade in every quarter of a full year.

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

The massive increase in international liquidity that followed found banks and non-bank financial institutions desperately searching for means to keep their capital moving. Extending their reach to markets abroad was the inevitable next step. In the early 1980s the volume of transactions of bonds and securities between domestic and foreign residents accounted for about 10 per cent of GDP in the US, Germany and Japan. By 1993 the figure had risen to 135 per cent for the US, 170 per cent for Germany and 80 per cent for Japan. Much of these transactions were of bonds of relatively short maturities. As a proportion of world output, net international bank loans rose from 0.7 per cent in 1964 to 8.0 per cent in 1980 and 16.3 per cent in 1991. Relative to world trade, net international bank loans rose from 7.5 per cent in 1964 to 42.6 per cent in 1980 and 104.6 per cent in 1991.

At first, there were booms in consumer credit and housing finance in the developed industrial nations. But when those opportunities petered out, the search resulted in the discovery of the so-called “emerging markets” of today, which are principally the more developed among the developing and transitional economies. These were economies which were earlier marginalised from the market for private international finance either because they were politically unacceptable or because they were not considered creditworthy. Their access to international liquidity was limited to what was available through the development aid network, making capital inflows to these countries autonomous and politically determined. This changed because of the new dynamic determining flows of international capital and encouraged a process of “securitization”, or capital flows in the form of stocks and bonds rather than loans.

From the point of view of the developing countries, this growth in international finance appeared positive. Needing liquidity to finance their post-oil shock deficits, they initially found it easier to negotiate with a relatively atomistic banking system that could impose no conditions rather than the centralised multilateral financial institutions like the IMF. Banks flush with funds were keen to lend, and the possibility that the rather high current account deficits they were financing were unsustainable was not considered. No level of the current account deficit was unacceptably high. What mattered was that the nature of the international financial system hitherto had kept the volume of commercial borrowing by these countries relatively low.

Thus, this congruence of interests - of the developing countries to borrow and the banks to lend - resulted in the fact that the current account deficit was for almost a decade and a half no constraint on growth in at least some underdeveloped countries. The fall-out of this scenario is now history. Right through the 1970s and 1980s governments in one developing country after another combined more liberal growth strategies with huge budget deficits financed with international borrowing, since that partly neutralised the adverse effects on domestic growth that liberalisation had. In fact, during those years many developing countries actually recorded rather creditable rates of growth, which were often attributed to liberalisation rather than the irresponsible pump-priming by domestic governments, which the irresponsible lending practices of the international banking system encouraged.

As a consequence of the growing interest in developing countries as "emerging markets" on the part of developed country financial interests, many countries opting for financial liberalisation attracted large volumes of foreign portfolio investment, which were not being undertaken with the intent of acquiring a "lasting", or even control-wise significant, interest in the firms concerned. Portfolio flows to developing countries in the form of investments in bonds, equities, certificates of deposit and commercial paper, rose from an annual average of \$1.3 billion during 1983-90 to \$19.1 billion during 1991-92 and \$80.9 billion in 1993 (World Bank 1994 and 1997). However, uncertainties of various kinds saw a decline to \$61.3 billion during 1994-95. Estimates suggest that this figure bounced back to \$91.8 billion in 1996, just before the East Asian financial crisis.

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

The combination of debt and portfolio capital had meant that for the last three decades, at least the more developed among the developing countries have found it much easier, excepting of course when crisis strikes, to access private foreign capital flows. This is

taken to imply that the rise to dominance of finance and its globalising influence has rendered the current account deficit in many developing countries less of a binding constraint.

But the boom obviously could not be consistent in all emerging markets. First, it became clear that none of these borrowers were in a position to meet their debt service payments, without resorting to further borrowing. This together with the evidence of the colossal overexposure of the international banking system in many developing countries set afoot the deceleration in the flow of liquidity that came to be called the 'debt crisis'. The banks of course could not pull out completely, because that would have spelt closure for many of them, as much of developing country debt would have had to be written off rather than rescheduled. But the problem went deeper, since with the rise to dominance of finance capital relative to industrial capital in the developed nations, the financial system was awash with liquidity, but creditworthy borrowers were difficult to come by in an increasingly recessionary environment. In the event, debt was replaced with other kinds of non-debt private capital flows. Here too, however, the evidence suggests that barring rare exceptions, periods of accelerated capital flow were followed by inevitable financial crises, when foreign investors turned wary and chose to withdraw their investments.

Not surprisingly, since the early 1990s, financial crises are the norm in those developing countries that were discovered as "emerging markets" by international financial capital. In fact, the number of instances of crises of significant dimensions has been growing. Among the major crises that have accompanied the rise of finance have been the crisis in the Southern Cone in the late 1970s; the Third World debt crisis of the early 1980s; the savings and loan debacle in the US in the late 1980s; India's balance of payments crisis in 1991; the so-call ERM crisis in 1992; the Mexican crisis of 1994-95 and its follow-on crisis in Latin America (Bello *et. al.*, 2000); the East Asian crisis of 1997; the Russian meltdown of 1998; the collapse of the *real* in Brazil and its impact on the rest of Latin America in 1998-99, the Turkish crisis in 2000, the Argentinian crisis which still has not gone away of 2001 and the more recent recurrence of volatility in Turkey.

The initial response to the debt crisis was to find acceptable ways of routing capital to the developing countries to prevent default. It was here that agencies like the IMF and the World Bank came in handy, linking credit flow to the developing countries to an appropriately designed "adjustment" package. This package which was acceptable to the developing countries caught in a virtual trap, involved curtailing central bank credit to the government, intensifying trade reform, dismantling regulations on national and foreign firms and agents, devaluing and moving towards a convertible currency, privatising the public sector, and in the new phase, reforming the financial sector. All of these were in keeping with the requirements set by the rise to dominance of international finance. Trade liberalisation and deregulation are inevitable elements of a strategy that provides the basis for international investments aimed at world-market oriented production that can be 'facilitated' with finance. Crucial resources in the hands of the State or the domestic private sector, like for example hydrocarbon resources, are rendered eligible for acquisition by foreign interests, so that real assets can serve as collateral for the financial transactions of foreign firms. And business conditions are made acceptable to financial agents through a liberalisation of the financial sector and a gradual shift towards convertibility for capital account transactions.

The problem was, however, that if finance was to use these markets as new avenues for investment and as a hedge against the risks in their own markets, the rules of the game had to correspond to those in their own market. It was this which made financial liberalization of a kind that seeks to replicate the Anglo-Saxon “model” a key demand of international finance. An excess of capital in the form of debt and equity investments began to flow into countries which were willing to liberalize rules relating to cross-border flows of capital, change the regulatory regime applicable to the financial sector (including the entry and operations of international financial agents) and regulations governing the conversion of domestic into foreign currency. The result of these developments was that there was a host of new financial assets in the emerging markets, which were characterized by higher interest rates ostensibly because of the greater risks of investment in these areas. The greater ‘perceived risk’ associated with financial instruments originating in these countries, provided the basis for a whole range of new derivatives that bundled these risks and offered a hedge against risk in different individual markets, each of which promised high returns.

As had happened in the domestic market, this growth was accompanied by the overexposure of banks to individual developing countries. This changed after the debt crisis of 1982, when banks burnt their fingers and withdrew. But financial flows to developing countries did not stop. It continued in the form of portfolio investments and securitised debt of different kinds. But for this to happen, financial liberalization policies of a kind that involved the replication of the Anglo-Saxon system had to be pursued.

Asymmetric fragility

The interesting feature of this period is that while the fragility of the developing countries increased substantially as a result (as illustrated by the almost routine reports of a financial crisis in one emerging market or the other, those of the banks and financial firms that entered or invested in these markets did not. There were a number of features that explain this apparent resilience of an otherwise fragile financial sector.

The first is the role of the Bretton Woods institutions in the new environment. Prior to the 1970s aid flows occurred through both bilateral and multilateral routes, and the BWIs were just one source of official financial flows. While this still remains true to an extent, the last three decades have seen a growing centralization of aid flows, with donors putting their debt into a single kitty, administered by the IMF and the World Bank. This relatively large kitty has been put into use to ensure orderly workouts whenever crisis afflicts a particular, with large IMF-Bank bail-out packages that both ensure that there is no default as well as no post-crisis retreat from financial liberalization. The first instance of this was in 1982, when Mexico temporarily suspended debt payments, and triggered widespread fears of bank failure and a collapse of the international banking system. The Baker plan announced by the then Treasury Secretary involved three features: (i) austerity measures by the Mexican government to curtail its demand for international liquidity and restore its ability to meet debt service commitments; (ii) balance of payments finance from the IMF, the World Bank and the regional multilateral development banks, supported with additional funds from the governments of creditor countries; and (iii) rescheduling of existing debt and some additional funding from the commercial banks to help tide over the situation. It was soon clear, however, that the real beneficiaries of this kind of exercise, which was repeated in other contexts as well, were

the banks. They found time to restructure their capital base and create loss-loan reserves that prevented closure despite high exposure. The debtor countries themselves found that they were saddled with recessionary conditions and persisting vulnerability.

In fact after the temporary debt default in Mexico, Brazil and a host of other countries, banks came to terms with the fact that their loans to these countries were worth considerably less than 100 cents in the dollar. So even while rescheduling debt they began of process of ridding themselves of such country loans at a discount. A secondary market for these loans developed, involving not just sovereign debt but corporate debt as well. Banks like J.P. Morgan in America and Swiss Bank Corporation (now part of UBS) in Europe, have since adopted a policy of holding as little of sovereign and corporate debt on their balance sheets as possible. A practice that was soon followed by other banks. This required selling these loans to smaller, traditional banks or to non-bank financial firms or transfer the risk to insurance companies. Through such a process of socialisation of the costs of fragility the banks substantially reduced their own vulnerability.

The second way in which the international financial system was insulated from fragility was by using the post-crisis adjustment and rescheduling process to get governments in developing countries to take over the burden of private debt or offer a sovereign guarantee on such debt, so that the banks could be saved from the damaging consequences of default. This came out starkly in South Korea when the IMF-negotiated bailout involved banks converting \$24 billion of short term debt into medium-term debt guaranteed by the government, at an interest rate ranging from 2.25 to 2.75 percentage points above LIBOR.

In fact, ever since the debt crisis and the rescheduling exercises that followed, international banks, while wary of developing-country lending, have been convinced that the losses they can incur in developing-country markets are limited by the implicit sovereign guarantee of loans to private borrowers, both by governments in the developed and developing countries. This is the case even when the loans that are made are not officially guaranteed by the governments of the debtor companies, because of the assumption that in cases of real difficulty governments will be forced to step in and underwrite such loans, with or without IMF pressure. That is the losses of the banks are financed by the taxes that would be paid subsequently by the populations of these countries to finance debt service payments.

This is a problem which still largely goes unmentioned in most mainstream analyses. As a consequence, none of the standard prudential norms which would have applied in the home countries was closely followed by creditors or other investors. The fact that the domestic banking and finance sectors in these countries were subject to prudential regulation was not an adequate safeguard against this, which turned out to have extremely dire implications for the borrowing countries. This points to the futility of believing that capital account convertibility accompanied by domestic prudential regulation will ensure against boom-bust volatility in capital markets. Capital flows continue despite periodic crises because international banks have had to pay little penalty, if anything at all, for their lack of diligence.

The final factor accounting of the asymmetry in the fragility characterizing the international financial system, on the one hand, and the emerging market developing

countries, on the other, is the replication of institutions and instruments characteristic of the Anglo-Saxon model. Financial restructuring involves restructuring of bank capital in developing countries financed by the state, aligning them with international “standards” and making them fit for take over by foreign banks and investors. Stock markets are suitably liberalised for entry and dominance by foreign investors looking for high speculative profits, justified in the name of “risk premia”. Local pension funds and mutual funds are encouraged to invest in market instruments. And, finally, new instruments such as derivatives and futures are created to allow foreign banks and firms to use the process of securitisation to transfer credit risk and insulate themselves from losses. In sum, financial fragility and financial crises in the developing countries do not threaten the viability of the banks, pension funds and institutional investors that expose themselves to differing degrees in those countries. Not surprisingly, capital flows continue, even if their geographical concentration is constantly changing.

The two facets of financial liberalization

It should be clear from the above discussion that the two facets of financial liberalisation – facilitating capital flows and restructuring the domestic financial structure - even if they do not occur at the same speed, are closely related. Countries seeking to attract capital flows are forced over time to restructure their financial systems in the image of the Anglo-Saxon model. This allows international financial agents not just a foothold in developing country financial markets, but the leverage to transform local financial structures in a manner that allows them to socialize risk in a manner they are attuned to doing at home.

This process of socialization in developing countries is far more intensive since besides their subordinate position they are subjected to scrutiny by the international financial institutions that increasingly centralize access to non-commercial sources of foreign finance. In the event, domestic fragility increases not just because of the volatility of financial flows but because of the change in the institutional structure of the financial system. Further, because the process of socialization of risk protects international financial interests, financial crises do not result in an end to all inflows. New kinds of flows – such as portfolio flows or foreign direct investment - substitute for debt in the wake of a debt crisis. This is because, financial liberalization not merely renders developing countries crisis prone, but forces a deflationary environment that not only has affects growth and human development adversely, but also permits acquisition of domestic assets by foreign investors at bargain prices.

In the circumstances focusing on means to regulate inflows or outflows alone would not do. The changed institutional structure sets up strong forces against the introduction of such controls and introduces an element of irreversibility with regard to the volume and volatility of flows that small measures cannot defeat. If, therefore, countries have not yet substantially reshaped their institutional structures, attempts at imposing capital controls must be accompanied by efforts to prevent the process of institutional change. If the process of institutional change has already begun, effort at imposing capital controls alone would not do. The process of clearing the grass to find the path to retrace the steps taken should also be initiated.

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