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reformed with the aid of auction quotas, the prices paid by consumers will not fall, for the supply on the market will always be below that which would be possible under free market conditions. Consumers will go on having to pay higher prices, and the only difference will be that part of the money which would otherwise have gone abroad will now flow into the coffers of the domestic government.

Conclusions

Bergsten's proposal is undoubtedly an interesting alternative to the trade-policy instruments traditionally used as far as importing countries are concerned because of the revenue prospects it raises. However, can the auction quota system really be seen as an alternative to voluntary restraint agreements? The main problem in converting such agreements into auction quotas is likely to be the resistance of the exporting countries. The very reason that voluntary export restraint agreements are concluded is to avoid tougher measures and to achieve a certain gain in the shape of the economic rent. If the auction quota system were to be introduced this would lead to new complaints at the GATT in Geneva, causing disruption to the relations between exporting and importing countries.

¹⁵ Cf. E. U. Petersmann, *op. cit.*, p. 35.

One point auction quotas do have in their favour is that they would again make protectionism more transparent and would hold in check the current tendencies towards discrimination.¹⁵ This would again allow restricted market access to become the object of international negotiations. Given the manner in which voluntary export restraints are currently practised, these agreements are most unlikely to generate complaints before the GATT. Yet the Uruguay Round negotiations would undoubtedly be simpler if precise figures were available on the extent to which trade is being restricted by such "voluntary" export restraints.

Auction quotas should only ever be used if it is certain that they are a true step towards the liberalization of world trade. This is something the exporting countries need to be convinced of, but it must equally be brought home to domestic, import-competing industries. If this were to be achieved, consumers too would ultimately benefit, for after a period of time goods really would be produced where the comparative advantage is greatest. But has this Heckscher-Ohlin world ever really existed? If looked at in this light Bergsten's proposal also needs to be treated with scepticism. Free trade still is, as it has always been, a concept which graces the textbooks on foreign trade theory but is rarely encountered in practice.

Uwe Corsepius*

Liberalisation of the Capital Markets in Developing Countries

The domestic capital markets of developing countries are typically subject to serious inefficiencies. This article shows how these inefficiencies can be eliminated without necessarily provoking an adjustment crisis and indicates the measures on which emphasis must be placed in the context of structural adjustment assistance in order to mobilise a large volume of savings and achieve a better allocation of resources.

Financing a volume of investment that will generate rapid and self-sustaining economic growth is a serious problem for most developing countries, and all the more so for the heavily indebted countries that must finance economic growth largely by their own efforts because little new external money is available. An efficient domestic capital market is therefore essential if

new productive capacity and jobs are to be created quickly. To facilitate this, credit institutions must be able to mobilise domestic savings to finance investment by tailoring the yield and liquidity characteristics of their deposit instruments to suit savers' requirements. In addition, the underlying economic conditions must give the banks an incentive to transform the savings they have gathered into loans and to distribute them among investors in a way that ensures efficient use of the

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capital from a macro-economic point of view. This presupposes that the banks are able to differentiate between borrowers in terms of the risk and expected return on the project they are being asked to finance.

Given the prominent role of the capital market in the growth process, many developing countries have tried to speed up their economic development by subjecting the market to far-reaching regulation. Among other measures, they have put ceilings on lending rates and laid down official criteria for credit allocation with the aim of ensuring that priority investments are financed. Experience shows, however, that the controls have missed their mark; theoretical and empirical studies have demonstrated that comprehensive regulation reduces the effectiveness of the capital markets.¹ The studies therefore conclude that a largely liberalised capital market might contribute more to economic development.

In the light of these findings, it could be expected that many developing countries would introduce capital market reforms, especially as in the eighties several of them are even more dependent than in the past on efficient domestic capital markets to finance and implement adjustment programmes designed to revive their stagnating economies. Consequently, the World Bank has also endorsed demands that developing countries abolish interest rate ceilings by making this one of the conditions for obtaining structural adjustment loans.² Developing countries are nevertheless showing considerable hesitancy about liberalising their capital markets. It can be assumed that their reluctance to change their policy towards the domestic capital market has been induced largely by the bad experiences with reform of this kind in a number of developing countries. For example, the liberalisation of the capital market in Chile led to a financial crisis in which many financial institutions were saved from bankruptcy only by the intervention of the state.³ The failure of the Chilean reform was due to inconsistencies both within the reform programme itself and between the capital market reform and other economic policy measures. Firstly, the banks were privatised and deregulated without first

establishing the necessary anti-trust and balance-sheet safeguards.⁴ Secondly, the freeing of capital movements was incompatible with pegging the exchange rate at the same time as indexing wages.⁵

Since an abortive capital market reform can entail heavy cost in terms of growth forgone and economic instability, many countries obviously find it preferable to continue to regulate and to accept the existing efficiency losses rather than embark on a reform with an uncertain outcome. Against this background, the aim of the present article is to show how the inefficiencies typically present in the domestic capital markets of developing countries can be eliminated without necessarily provoking an adjustment crisis and to indicate the measures on which emphasis must be placed in the context of structural adjustment assistance in order to mobilise a large volume of savings and achieve a better allocation of financial resources.

Higher Real Interest Rates

The majority of authors agree that capital market reforms in developing countries where government controls hold real interest rates on deposits below the equilibrium level must lead to higher real interest rates on savings. However, in general they omit to say how such an increase is to be brought about. In principle, nominal interest rates can be raised or indexed or the rate of inflation can be reduced. Theoretical considerations and empirical studies both show that raising nominal interest rates is not enough to mobilise savings; the inflation risk must also be reduced to make financial investments attractive by comparison with real assets, such as precious metals and durable consumer goods.⁶ This could be achieved either by taking measures that reduced both the level and volatility of inflation or by indexing interest rates. However, if one considers that the ultimate objective of capital market reform is to increase the volume of investment and the efficiency of resource allocation, it is clear that inflationary tendencies must be curbed; otherwise there is no guarantee that private enterprises will use the additionally mobilised savings to finance fixed

¹ Cf. Bernhard Fischer: *Liberalisierung der Finanzmärkte und wirtschaftliches Wachstum in Entwicklungsländern*, Kieler Studien, No. 172, Tübingen 1982; Maxwell J. Fry: *Money, Interest and Banking in Economic Development*, Baltimore 1988.

² Cf. Constantine Michalopoulos: *World Bank Programs for Adjustment and Growth*, in: Vittorio Corbo, Morris Goldstein, Moshin Khan (eds.): *Growth-oriented Adjustment Programs*, International Monetary Fund and the World Bank, Washington 1987, pp. 15-62.

³ For a detailed description of the capital market reform in Chile and subsequent developments up to 1984, see Roberto J. Behrens Fuchs: *Los bancos e instituciones financieras en la historia económica de Chile 1811-1983*, Pontificia Universidad Católica de Chile, Instituto de Economía, Santiago 1985.

⁴ Cf. Jose P. Arellano: *De la liberalización a la intervención: el mercado de capitales en Chile: 1974-83*, in: *Colección Estudios Cieplan*, No. 11, 1983, Estudio No. 74, pp. 5-49.

⁵ Cf. Larry A. Sjaastad: *Liberalization and Stabilization Experiences in the Southern Cone*, in: Nicolás Ardito Barletta, Mario T. Blejer, Luis Landau (eds.): *Economic Liberalization and Stabilization Policies in Argentina, Chile, and Uruguay*, The World Bank, Washington 1984, pp. 83-103.

⁶ For further aspects of the successful mobilisation of savings capital, such as the flexible configuration of savings instruments, see Uwe Corsepius: *Savings Mobilisation in Developing Countries*, in: *INTERECONOMICS*, Vol. 23, 1988, No. 1, pp. 30-34.

investment. For several reasons, a high inflationary risk makes it difficult for potential investors to forecast likely returns:

□ On the demand side, fluctuating inflation rates hamper the projection of demand trends, as it is difficult for enterprises to distinguish between price rises that indicate excess demand and those that are part of the general inflationary trend.

□ On the costs front, unexpected changes in the inflation rate affect the profitability of investments, because the real cost of finance varies with the inflation rate and because tax laws, depreciation principles and book-keeping guidelines are based on nominal values.⁷

□ In developing countries with rapid inflation it is also more difficult for firms to optimise their production structure on the basis of price signals, since relative prices also fluctuate with the rate of inflation.⁸

High inflation rates do not necessarily reduce the profitability of individual investment projects, but the investment risk increases, since the expected return on an investment is subject to greater uncertainty owing to the variability of inflation. Risk-averse investors will therefore build a risk premium into their calculations and

invest only in short-term projects with high expected yields.⁹ Successful capital market reform therefore calls for the stabilisation of inflation; indexing financial contracts is not enough.

Improvement in the Banks' Performance

Raising real interest rates is not sufficient to achieve the gains in efficiency expected to flow from capital market reform. In the majority of developing countries multiple layers of regulation prevent the credit institutions from attracting greater savings and improving their lending by exploiting their new-found freedom to set interest rates.

In some developing countries, low interest rates on central bank lending and fixed but overvalued exchange rates mean that it is more beneficial for banks to borrow from the central bank or abroad than to attract deposits. Such effects can be avoided if the credit institutions' refinancing limits are tied to the volume of their deposits. Correction of the exchange rate would reduce the attraction of foreign borrowing and at the same time might encourage the return of savings deposited abroad. However, it is doubtful whether this is sufficient to induce the financial intermediaries to invest in improving their range of savings instruments. The existence of external effects resulting from the introduction of new modes of saving can deter the individual bank from widening its product range.¹⁰ For example, if savers must first be educated in the formal requirements of keeping savings accounts, the efforts made by individual banks also benefit their competitors. Hence individual banks will not break new ground. In this case state intervention would be justified. For example, the initial investment costs could be covered by a specific subsidy paid for a limited period.

Other measures must also be taken to ensure that once the capital market has been reformed loans are

⁷ Even inflation accounting is not free of inflation-induced distortions, since inflation rates cannot be predicted perfectly; see John A. Halloran, Howard P. Lanser: Inflation-Induced Biases in the Evaluation and Selection of Capital Investments, in: *The Financial Review*, Vol. 18, 1983, No. 4, pp. 314-325.

⁸ Cf. Stanley Fischer, Franco Modigliani: Towards an Understanding of the Real Effects and Costs of Inflation, in: *Weltwirtschaftliches Archiv*, Vol. 112, 1978, No. 4, pp. 810-833.

⁹ For a theoretical treatment and an empirical test using Peru as an example, see Uwe Corsepius: *Kapitalmarktreform in Entwicklungsländern – Eine Analyse am Beispiel Perus*, Kieler Studien 225, Tübingen 1989.

¹⁰ Cf. Paul Burkett: Interest Rate Restrictions and Deposit Opportunities for Small Savers in Developing Countries: An Analytical View, in: *Journal of Development Studies*, Vol. 23, 1986, No. 1, pp. 77-92.

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also available to borrowers who had previously been subject to credit rationing. Otherwise, the credit institutions might deposit the additional funds abroad or invest them in domestic securities. It is also possible that loans would still be available only to firms that had access to credit before the reform. Assessing the creditworthiness of potential borrowers is made more difficult if the government's future economic policy remains unclear or displays obvious inconsistencies. If that is the case, the banks must expect to be caught unawares by measures that impair the quality of their loan portfolio. They will therefore assess the risk of loan defaults over which they have no influence themselves as fairly high, thus reducing their income per loan. Increasing lending rates would offset only part of the higher loan loss ratio, however. Irrespective of the interest rate elasticity of credit demand, an increase in lending rates causes the loan default ratio to rise, so that there can be an income-maximising lending rate at which there is still unsatisfied credit demand.¹¹ Likewise, a higher ratio of loan securities to the volume of lending can increase the expected return only to a marginal extent. As an increasing proportion of credit is secured, borrowers will give preference to more risky projects that promise higher returns if successful. However, this also increases the risk of loan default and defeats the positive effect of additional guarantees. Hence it can make sense for the credit institutions not to expand the supply of credit despite the reform of interest rates and to give preference to other forms of investment in view of uncertainty.

Domestic securities are particularly attractive if there is a high risk of loan default and a likelihood of a nominal revaluation of the domestic currency. The expected yield on domestic securities is then higher than the return on loans or foreign deposits, even though the last two forms of investment may bear higher nominal interest rates. On the other hand, banks will prefer deposits abroad to domestic lending if they judge the exchange rate risk to be slight and if the return adjusted for exchange rate changes is higher than average domestic lending rates adjusted for the loan default ratio. This situation may arise, for example, if the banks expect the exchange rate of an overvalued currency to be adjusted.

The negative effects on the expected yields on domestic lending in comparison with those on alternative forms of bank investment can be avoided by

pursuing an appropriate economic policy. To reduce the attractiveness of foreign investments, it would be necessary to avoid predictable devaluations, on the one hand, and a substantial permanent differential between real interest rates at home and abroad, on the other. A system of flexible exchange rates would be the most appropriate way of achieving this. An intrinsically consistent and predictable economic policy can help reduce the expected rate of loan defaults. This requires that the government announce its future economic policy and commit itself to a definite timetable. The financial intermediaries can then estimate the effects of future measures and avoid granting excessive credit to the firms most at risk.

Loans for New Categories of Borrower

Even if the banks use the additional deposits to finance new loans, in many developing countries only certain categories of borrower will benefit unless further measures are taken. In many cases banks and large companies are interlinked through reciprocal shareholdings, via holding companies or through personal links.¹² In these countries the fact of being a group member company is often an important precondition for access to credit. However, intra-group lending cannot ensure that the investments financed are efficient from the macro-economic viewpoint. Moreover, banks ignore the need to diversify their risks if they concentrate on lending to group member companies operating in only a few industrial sectors. The portfolio constraints applied in some developing countries, which limit the proportion of loans that banks can grant to companies in their own group, provide only a partial solution to these problems. Even assuming that the regulations are not circumvented via holding companies, there is scarcely a rational way of setting the limits; for example, it cannot be ruled out that investment projects by group member companies will earn a higher return than those of other companies. Portfolio constraints therefore make sense only as a temporary measure, while the longer-term aim must be to sever capital links and interlocking directorships. For that to happen, the necessary anti-trust laws must be passed and a supervisory authority with appropriate powers put in place.

Capital market reform is successful only if it also succeeds in making bank loans accessible to small firms, which in developing countries are typically forced to rely on informal financial markets and self-financing. It can be assumed that after living with interest rate ceilings for a fairly long period during which they lent mainly to large companies offering good security, the

¹¹ Cf. Joseph E. Stiglitz, Andrew Weiss: Credit Rationing in Markets with Imperfect Information, in: *American Economic Review*, Vol. 71, 1981, No. 3, pp. 393-410.

¹² Cf. Vincente Galbis: Financial Sector Liberalization under Oligopolistic Conditions and a Bank Holding Company Structure, in: *Savings and Development*, Vol. 10, 1986, No. 2, pp. 117-140.

banks will initially have neither the expertise nor the information to extend their lending to smaller enterprises.¹³ In developing countries small firms are often concentrated in the informal sector of the economy. Most of them have few fixed assets and can therefore offer little by way of loan guarantees. Moreover, they are unlikely to have the kind of bookkeeping required of enterprises in the formal sector. This company structure, which is tailored to suit the shadow economy, increases the information costs for banks from the formal sector and also makes it very difficult to take legal proceedings against a defaulting debtor. The costs and risks of lending to informal debtors require very high interest rates. Since the risk of loan default increases with the lending rate, it is feasible that there is no interest rate at which a loan to an informal enterprise will earn the bank a profit.

The situation may be eased by a policy that removes the reasons for the development of the shadow

economy and thus brings about a gradual conversion of informal enterprises into formal ones. This reduces the banks' transaction costs, enabling them to compete with the informal financial intermediaries, who were previously at an advantage. Apart from improving the macro-economic allocation of loans, this will also curb the monopoly power often enjoyed by informal financiers. A reform package aimed at improving the access of informal enterprises to the formal financial market must also remove discrimination against informal borrowers. In particular, a legal framework must be created in which the widest possible variety of assets can be accepted as loan collateral. For example, if only plant and machinery can be used as collateral, loans to small family firms can generally not be secured, since small enterprises can usually offer only land, houses or savings deposits as security. The supply of credit to small enterprises could be improved if loans could also be secured by personal guarantees. The presence of a wealthy guarantor significantly reduces the bank's credit risk. The guarantor is better able to assess the credit risk on account of personal or business relations with the borrower and can obtain repayment more easily in the event of default. On the other hand, experience militates against granting group loans, in which borrowers are formed into a group and accept joint liability for the loan. If the guarantees provided are really to reduce the risk of loan default for the banks, legal procedures must also be available for bringing bad debtors to court quickly and disposing of their securities.

Reduction of Intermediation Costs

In many developing countries the banking sector's performance as credit intermediary can also be improved by minimising the resources consumed by the financial system in intermediating between savers and investors. Excessive consumption of resources limits the maximum possible volume of deposits at a given lending rate and hence reduces the macro-economic advantages to be expected from a rise in real interest rates. Intermediation costs consist of the banks' profits and their costs for the production of deposits and loans. Excessive intermediation costs in developing countries can be attributed to several factors:

□ The low level of competition makes it possible for the credit institutions to co-ordinate their interest rate policies after an interest rate reform. By widening the spread between deposit and lending rates, they can maximise profits or afford higher costs than are necessary. Such behaviour is protected by state

Table 1

Size of the Equity Market in Selected Industrial and Developing Countries, 1980-86

	Value of share issues as percentage of GDP			Value of share issues as percentage of M2 ^a		
	1980-81	1982-84	1985-86	1980-81	1982-84	1985-86
Industrial countries						
Canada	40.1	38.7	43.9	83.3	83.9	100.5
France	7.4	6.9	17.9	15.5	14.9	38.3
Germany	9.0	11.9	29.1	16.6	21.2	49.6
Japan	35.3	45.4	81.3	40.3	48.6	81.7
USA	49.2	51.8	61.0	86.7	86.2	95.6
Developing countries						
Argentina	2.1	1.8	2.5	6.9	5.7	11.4
Brazil	4.1	8.4	17.5	35.4	74.8	134.4 ^b
Chile	27.8	14.1	18.4	93.7	42.8	n.a.
Colombia	4.3	2.6	1.9	20.6	12.2	8.7 ^b
India	6.7	5.7	8.6	16.6	13.1	18.6
Malaysia	55.9	61.7	53.1	103.7	104.7	77.0
Mexico	5.6	1.8	3.5	17.9	6.0	13.1
Nigeria	3.5	3.4	3.7 ^b	11.9	9.7	8.3
Pakistan	2.9	3.8	5.0	7.2	9.1	12.2
Peru	4.5	5.1	— ^c	17.7	19.0	— ^c
Philippines	5.2	3.1	5.2	24.5	13.4	24.7
South Korea	6.1	6.3	11.3	18.3	17.1	29.4
Thailand	3.2	3.8	5.9	8.6	7.8	10.0
Venezuela	4.1	2.6	2.6	11.5	5.8	5.0
Zimbabwe	14.0	4.9	7.6	39.8	16.0	27.4

^a Cash, demand deposits and quasi-money. ^b Only 1985. ^c Comparable data for Peru are not available.

Sources: Banco Central de Reserva del Perú: Memoria 1985, Lima 1986; International Finance Corporation, Capital Markets Department: Emerging Markets Data Base, Selected Tables, Washington, March 1988; International Monetary Fund: International Financial Statistics, Washington, various years; Manuel A. Cobo del Prado Collado: Diagnóstico del mercado de capitales peruanos, CONASEV, Lima 1984; own calculations.

¹³ Cf. Yoon Je Choo: On the Liberalization of the Financial System and Efficiency of Capital Allocation under Uncertainty, Stanford 1984.

restrictions on market entry that prevent the emergence of new competitors. As in the industrial countries, the regulation and protection of the banking sector is justified on the ground of special circumstances in the sector and the need for stability in the financial system.

□ High and often non-interest-bearing minimum reserves lead to a widening of interest rate spreads by increasing the banks' costs. Portfolio constraints, which oblige banks to lend at subsidised interest rates to certain types of borrower such as farmers, have a similar effect.

□ High inflation rates usually increase bank profits, since demand deposits do not bear interest, so that the banks' average interest costs decline. Moreover, fluctuations in inflation rates increase the banks' production costs, since the risk of interest rate changes rises and the term of loan contracts shortens.

Consideration of the factors determining intermediation costs therefore also indicates that reform of the capital market must include action to curb inflation. Further improvements in efficiency can be achieved if the banking sector is deregulated and exposed to keener competition. The combination of a supervisory authority with the necessary powers and an appropriate deposit protection scheme could ensure the stability of the financial system. Liberalisation of market entry for foreign banks and domestic informal financial intermediaries helps to increase competition and forces the banks to adjust their costs and profits to the level dictated by competition.

Stimulation of Equity Markets

The equity and securities markets are of only limited importance in the economies and national financial systems of most developing countries (see Table 1). Even in those countries that have relatively active equity markets the value of share issues in relation to gross domestic product was significantly lower than in industrial countries between 1980 and 1986, except in the case of Malaysia. However, small equity and securities markets do not generally function efficiently. The risks for investors are too great, since every transaction can affect the market price and there is only limited scope for portfolio diversification. Moreover, the small size of transactions makes insider trading easier, so that a section of the market is systematically disadvantaged.

However, it would be wrong to write off equity markets in developing countries because of these problems, as some authors have suggested.¹⁴ Only equity markets

can provide the risk capital needed for long-term investment projects. Sole reliance on bank loans cannot ensure that the investments with the highest expected returns will be financed. Credit institutions are more likely to prefer low-risk, low-return projects over those promising high yields and entailing correspondingly high risks, for if the project fails they will have to forego repayment, but interest payments do not rise in proportion to profits. Furthermore, the equity and securities market widens the range of investments for savers and makes it possible to privatise public enterprises. Capital market reform can therefore not do without equity and securities markets but must eliminate the reasons why they are relatively small.

Detailed reform proposals can be made only on the basis of an analysis of the country in question, but a number of general approaches to the problem of stimulating the demand for and supply of shares and securities in developing countries can be discussed.¹⁵ It can be shown that a potential demand for shares and securities does exist in developing countries. The main obstacles to mobilising this demand are the yield risk for small shareholders and investment constraints for institutional investors. The lack of an information infrastructure and the limited scope for diversification greatly increase the risk for small shareholders. Share and bond-based investment funds may ease the problem, since in gathering information they draw advantage from economies of scale and are more likely to be able to spread their risks.¹⁶ If insurance companies and banks are also to emerge as investors, it can be expected that the growth of the equity and securities markets will not be hampered by lack of demand.

The elimination of restrictions on access by small and medium-sized enterprises is also of paramount importance for stimulating the supply of shares and securities. In many developing countries smaller enterprises are shut out of the risk capital market by minimum size requirements and disclosure rules. The limited supply of securities cannot, however, be attributed to excessive issue and transaction costs. Since in theory there is no reason why large companies

¹⁴ See for example Andrea Calamanti: *Securities Markets and Underdevelopment – The Stock Exchange in the Ivory Coast, Morocco, Tunisia, Finafrica*, Milan 1983, p. 90.

¹⁵ For details, see Uwe Corsepius, *op. cit.*, 1989, pp. 96 ff.

¹⁶ With regard to the experiences with share and bond-based investment funds in various developing countries, see United Nations Secretariat: *Development of Stock Exchanges in Developing Countries*, in: United Nations, Department of International Economic and Social Affairs (ed.): *Savings for Development, Report on the Second International Symposium on the Mobilization of Personal Savings in Developing Countries*, New York 1984, pp. 21–35.

should be the only ones able to offer their shareholders an attractive return on their capital, reforms are necessary. They should aim to make the expected profitability of an undertaking the criterion for admission to the stock exchange rather than size and should leave it to potential investors to decide whether they consider the enterprise sound. The share and securities market could be divided vertically according to the severity of requirements for admission to the stock exchange; large companies wanting to spread the ownership of their shares widely would have to provide more and better-prepared information than small firms seeking to interest only a small circle of professional investors. The classification of enterprises according to market segment by the stock exchange supervisory authority gives investors an initial indication of the risk attaching to the companies' shares. Firms in the less regulated segments can then offset the lower protection given to shareholders by offering higher yields.

In addition, limits on individual investors' holdings and the use of non-voting shares bearing entitlement to a percentage of profits may help to dispel proprietors' fears that issuing shares would excessively dilute their control. However, all attempts to stimulate the share and securities market will be to no avail if economic and political stability is not assured. A share is a risk-bearing instrument and its price at a particular moment is determined by the assessment of future prospects at that time. It is therefore highly sensitive to erratic swings in monetary and fiscal policy and uncertainty about future political developments.

Problems of Implementing Reforms

Comprehensive reform of the capital market is seldom implemented at a time of full employment and balance-of-payments equilibrium; it is more likely to be one element in a package of adjustment measures in response to a balance-of-payments crisis. Programmes to cope with balance-of-payments crises typically also include measures to liberalise foreign trade and make the labour market more flexible. Capital market liberalisation must therefore be co-ordinated with the other reforms, as otherwise the various measures may counteract one another and the growth effects will not materialise.

Reform of the labour market makes it easier for the reallocation effect of reforming the capital market and foreign trade to emerge if it is begun before or at the same time as the other liberalisation measures. Moreover, liberalisation of the domestic financial market should precede the abolition of controls on capital

movements.¹⁷ If exchange controls are removed without first ensuring positive real interest rates, substantial capital outflows into attractive financial investments abroad may destabilise the domestic financial market. Similarly, prior liberalisation of the domestic capital market may facilitate the subsequent reform of foreign trade, since additional credit is available to ease the restructuring of production. Clearly, the chances of success are greatest if domestic liberalisation is carried out before the liberalisation of external transactions.

On the other hand, there is disagreement as to the sequence of the reform of foreign trade and the liberalisation of capital movements.¹⁸ It is widely held that simultaneous implementation would be best, but cannot be achieved because of the high adjustment costs. The view that foreign trade should be liberalised before capital movements is justified primarily on the grounds that large capital inflows will otherwise cause a real appreciation of the currency, whereas successful reform of foreign trade typically requires a real depreciation.¹⁹ The adjustment costs induced by contrary movements of the real exchange rate can be avoided if foreign trade is liberalised first, since goods markets react more slowly than capital markets. One argument that goes against this line of reasoning, however, is the fact that capital inflows on the scale experienced by Argentina, Chile and Uruguay in the seventies are unlikely to occur for the majority of developing countries today. There is also a danger of mismanaging the exchange rate in the course of reforming foreign trade. This can be avoided if restrictions on capital movements are removed first and a flexible exchange rate is introduced.²⁰

Overall, the risks of setting a "wrong" exchange rate are no less than the dangers that may stem from destabilising capital inflows. Hence the relative risks and probabilities of success of both sequences of events should be examined before measures to reform the capital market are decided.

¹⁷ See for example Mario T. Blejer, Silvia Sagari: *The Structure of the Banking Sector and the Sequence of Financial Liberalization*, in: Michael Connolly, Claudio González-Vega (eds.): *Economic Reform and Stabilization in Latin America*, New York 1987, pp. 93-107.

¹⁸ For a detailed exposition, see Uwe Corsepius, *op. cit.*, 1989.

¹⁹ See for example Sebastian Edwards: *Sequencing Economic Liberalization in Developing Countries*, in: *Finance and Development*, Vol. 24, 1987, No. 1, pp. 26-29; Jacob A. Frenkel: *Economic Liberalization and Stabilization Programs*, in: Nicolás Ardito Barletta, Mario T. Blejer, Luis Landau (eds.), *op. cit.*, pp. 12-17.

²⁰ Cf. Deepak Lal: *The Political Economy of Economic Liberalization*, in: *The World Bank Economic Review*, Vol. 1, 1987, No. 2, pp. 273-299.