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## Financial liberalization and poverty: channels of influence

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**Working Paper No. 411**

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**Financial Liberalization and Poverty:  
Channels of Influence**

by

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## INTRODUCTION

It is undeniably the case that financial development and its effects on economic growth and development has been one of the most prolific areas of research in the fields of development, finance and international economics. Despite these developments, though, there has been little work on the relationship between financial liberalization and poverty. Related literature has been, to a great extent, based on the neoclassical view that financial liberalization mobilizes savings and allocates capital to more productive uses, both of which help increase the amount of physical capital and its productivity. By this means, financial liberalization increases economic growth. The logic follows that economic growth caused by (or accompanied by) financial liberalization increases incomes and therefore reduces poverty. A distant exception may be Fry (1995), who in surveying the limited work on this issue, concludes that “financial repression and the ensuing credit rationing worsen income distribution and increase industrial concentration” (p. 205). By implication, then, financial liberalization and the ensuing freeing of credit markets improve income distribution and poverty. Nonetheless, one would expect the economic and institutional changes brought about by a financial liberalization package to have a more complex effect on the living conditions of the poor than merely through the presumed growth channel and the simplistic view summarized by Fry (1995). In this paper, we investigate two further channels of interest, in addition to the growth channel: the crises channel and the access to credit and financial services channel.

Many economists agree that financial sector reforms have produced disappointing results and have failed to meet expectations. In some countries, financial markets were liberalized prematurely due to a failure to recognize their imperfect characteristics; indeed, in many cases all those attempts led to financial crises (Arestis and Glickman, 2002). It is possible that the poor might be more severely affected from such crises. The second channel that we investigate, the crisis channel, works via the changes in the macroeconomic dynamics, increasing volatility and vulnerability to financial crises following liberalization. In the third channel that we study, we evaluate the evidence regarding changes in poverty caused by better access to credit and financial services that financial liberalization is expected to yield. To the extent that a liberalization program increases the financial resources available to the previously disadvantaged and to the extent that the poverty problem is related to lack of consumption smoothing mechanisms, there is room for financial liberalization to help alleviate poverty.

The main message that we get from reviewing the literature is that there is still no clear understanding of the mechanisms underlying the way moving from financial repression to a liberalized regime influences different segments of the population and, in particular, the poor. A straightforward application of the standard liberalization policies without taking any measures to protect the initially disadvantaged groups of the population from potential losses can worsen the living conditions of these groups.

The article is organized into the following sections: in the next section, we describe the definition of financial liberalization that we adopt. This is followed in the subsequent three sections by an investigation of the three channels through which financial liberalization is expected to have an effect on poverty. A final section summarizes and concludes.

## **DEFINING FINANCIAL LIBERALIZATION**

The term financial liberalization takes various meanings in the literature. In this article, we adopt the multidimensional definition given in Kaminsky and Schmukler (2003). Financial liberalization consists of the deregulation of the foreign sector capital account, the domestic financial sector, and the stock market sector viewed separately from the domestic financial sector.

The liberalization of the capital account is captured by the regulations on offshore borrowing by financial institutions and by non-financial corporations, on multiple exchange rate markets and on capital outflow controls. In a fully liberalized capital account regime, banks and corporations are allowed to borrow abroad freely. They may need to inform the authorities but permission is granted almost automatically. Reserve requirements might be in place but are lower than 10 percent. Also, there are no special exchange rates for either the current account or the capital account transactions; nor are there any restrictions to capital outflows.

A fully liberalized domestic financial system is characterized by lack of controls on lending and borrowing interest rates and certainly by the lack of credit controls, i.e. no subsidies to certain sectors or certain credit allocations. Also, deposits in foreign currencies are permitted. In a fully liberalized stock market, foreign investors are allowed to hold domestic equity without restrictions and capital, dividends and interest can be repatriated freely within two years of the initial investment. According to Kaminsky and Schmukler (2003), full financial liberalization

occurs when at least two of the three sectors are fully liberalized and the third one is partially liberalized. A country is partially liberalized when at least two sectors are partially liberalized.

This way of defining financial liberalization follows the experience of countries, both developed and developing, since the early 1970s. Kaminsky and Schmukler (2003) provide indexes that help to shape the pattern of financial liberalization for both developed and developing countries. Broadly speaking, two episodes of financial liberalization can be identified: the first took place in the 1970s and the second in the late 1980s. Stock markets in developed countries were liberalized in the early 1970s, while the domestic financial sector and capital account were “repressed” until the early 1980s. Liberalization of the domestic financial sector predates the opening of capital account in the rest of the 1980s. So that by the mid-1980s developed countries liberalized, at least partially, their domestic financial sector. By the late 1980s and early 1990s capital account liberalization had taken place in all developed countries. In developing countries, domestic financial sector was liberalized along with capital account in the 1970s. However, the stock market was out of reach for foreign investors over the period. That epoch came to an end with the 1982 debt crisis, when controls were re-imposed that remained in place until the late 1980s (especially capital account controls) when a liberalization wave took place in Asia and then in Latin America. By the early 1990s, the domestic financial sector and stock market had been jointly deregulated in developing countries. This predates capital account liberalization, which only commences in the early 1990s. These are, of course, generalizations. Looking more closely at the dates of financial liberalization (see Kaminsky and Schmukler, 2003, Table 1), further differences emerge. All the G-7 countries deregulate the stock market first. European countries adopt a more mixed approach (25 percent liberalize the domestic financial sector first with the rest deregulating the stock market first. Latin American countries liberalize the domestic financial sector first. Asian countries follow a mixed strategy: some deregulate the domestic financial sector, while some others the stock market. Capital account liberalization in all Asian countries takes place subsequently.

## **THE ECONOMIC GROWTH CHANNEL**

One channel through which financial liberalization can affect poverty is through economic growth. Obviously, the existence and strength of the link between financial liberalization and poverty depends on the existence and strength of the links between, first, financial liberalization

and growth and, second, between growth and poverty. Proper understanding of this channel requires, therefore, full analysis of the two links to which we have just referred. As we describe below, there are problems associated with the soundness of both links. We discuss in the rest of this section both the theory and the empirical evidence when evaluating these two relationships. This particular channel can be thought of as relying on the theory of financial liberalization as developed originally by McKinnon (1973) and Shaw (1973). We begin with the relationship between financial liberalization and economic growth and/or economic development.

### **Financial Liberalization and Economic Growth**

In financial liberalization theory, financial repression, i.e. distortions of financial prices such as interest rates, reduces the real size of the financial system relative to the non-financial, which leads to slow real rate of economic growth (McKinnon, 1973 and Shaw, 1973). The theory rests on the assumptions that saving is an increasing function of real rate of interest on deposits and real rate of growth in output and that investment is a decreasing function of the real loan rate of interest and an increasing function of the growth rate. At the initial repressed stage, the nominal interest rate is administratively fixed, and thus the real rate is kept below its equilibrium level. Low interest rates encourage current consumption and discourage saving. Ceilings on loan rates reduce the average efficiency of investment projects since investments with lower returns that would not be profitable under the higher equilibrium interest rate, are now profitable. Removing the ceiling on interest rates leads to an increase in saving, as rising real interest rate traces the saving curve. The average return to investment increases, as the low-yielding projects are no longer profitable. Rising efficiency of investment leads to increased output, which further increases saving. Therefore, according to this theory, in an environment where investment opportunities are plentiful but the financial system is repressed, the key to higher and more efficient investment is to raise the return to savers, i.e. the real interest rate.

Liberalizations of the stock market and the capital account, two important dimensions of financial liberalization, are also thought to have positive effects on economic growth. Rising global linkages via cross-border financial flows can increase economic growth through various channels. First, financial integration of a poor country, in terms of its capital endowment, to the rest of the world results in higher investment in the country as capital flows in to earn higher returns (Prasad et al, 2003). Second, improved risk allocation reduces risk premium, thereby lowering the cost of raising capital (Prasad et al, 2003; Bekaert, Harvey and Lundblad, 2000,

2001). Global diversification of risk can increase investment in riskier but higher expected return projects that were shunned before (Obstfeld, 1994). Third, transfer of technology and managerial know-how can raise aggregate productivity and in turn help increase economic growth (Prasad et al, 2003). Fourth, integration can help the domestic financial sector by increasing incentives for improving the regulatory and supervisory framework for banking, by letting foreign banks introduce a variety of new financial instruments and techniques or by increasing competition which can improve the quality of domestic financial services (Prasad et al, 2003).

It has also been shown in the literature that it is possible for the financial liberalization process to have a negative effect on growth. Devereux and Smith (1994) study the effect of international risk sharing (portfolio diversification) in a multi-country world in which growth is based on the spillover effects of human capital accumulation. Their assumption of constant relative risk aversion preferences generates a positive relationship between the country-specific income risk and the average growth rate of the economy through the saving rate. Financial openness, by eliminating country-specific income risk, eliminates the impact of this risk on saving and therefore on growth. In other words, when countries share endowment risk via international capital markets, saving and growth rates can be lower in financial openness than in autarky. The main result of the Devereux and Smith (op. cit.) model holds when countries differ in their productivity risks instead of in their income risks. However, this model has been criticized in that the results hold only when there is only one investment technology available (Agenor, 2002). When there is more than one technology available, financial openness may increase the growth rate (although it can reduce saving rate as before) via a reallocation of savings to higher risk but higher return projects.

Much criticism of the financial liberalization theory has been conducted on the dubious assumption that markets, if left to themselves, will work reasonably efficiently. Another important critique has been launched on one of the critical assumptions of the thesis that for the financial liberalization and growth link to work savings would increase following financial liberalizations. However, there is no unanimous agreement on this issue. The relationship is complex, not only because there are short-term and long-term effects involved, but also financial liberalization is a process with many dimensions. Here are some of the channels mentioned in the literature: First, financial deregulation, by increasing competition among the providers of financial intermediation, boosts borrowing by agents that were constrained before

in the financially repressive regime (Bayoumi, 1993). This will lead to a fall in saving. Second, if financial liberalization involves the foreign exchange market, it may induce large capital inflows, which may result in a surge in real income and a positive direct but transitory effect on saving. Third, the liberalization of interest rates may discourage saving, if the income effect dominates the substitution effect. Fourth, the liberalization of the stock market could provide a wider range of saving instruments and help channel funds into the formal financial sector from the informal sector. The effect on total saving is, however, ambiguous (Bandiera et al, 2000).

Gibson and Tsakalotos (1994) group the critique on the financial liberalization thesis into two main areas. The first critique includes the Keynesian and neo-structuralist critiques. The second critique emphasizes the microeconomic failures that are prevalent in financial markets. These critiques show how much the outcome of the financial liberalization hypothesis depends on the assumptions made. The Keynesian models stress the role of effective demand. In these models a rise in the deposit interest rate increases the marginal propensity to save and therefore reduces aggregate demand. If aggregate demand and output fell, then the rate of profit would be reduced and, thereby investment would decrease. As a result, investment in a financially liberalized economy could be lower than that in a repressed one (Burkett and Dutt, 1991). This outcome stands in sharp contrast to that of the financial liberalization thesis. The neo-structuralist view agrees with the Keynesian view in that, following the removal of deposit interest rate ceilings, an increase in the desire to save reduces aggregate demand and makes contraction more likely than growth. It adds that as the rate of interest and bank deposits increase, the availability of credit may or may not increase. If deposits come from assets that were previously unproductive (such as jewelry) then total availability of credit increases. But if deposits flow to the banking system from the informal sector, then the total supply of credit in the economy could contract, since banks are subject to reserve requirements while the informal market is not (Taylor, 1983). Within such a framework, the overall outcome is far from beneficial; output and investment fall and inflation rises as rising interest rates increase the cost of capital. Therefore, financial liberalization is stagflationary, which is very much similar to the experience of some developing countries.

Stiglitz and Weiss (1981) made the main contribution to the second area of criticism. Their work showed that credit rationing is not special to repressed financial regimes and is not necessarily eliminated in financial markets after interest rate liberalization, as the literature on financial liberalization usually assumes. Information failures in loan markets may lead to credit



rationing by banks. The argument is as follows: At higher interest rates, the overall riskiness of bank portfolios becomes higher since the less risky projects are not profitable at the ongoing interest rate and thus firms switch to riskier projects. Moreover, using high interest rates as a screening device may attract bad loans, since borrowers who are willing to pay high rates may be less worried about whether they will be able to pay back the loan or not. As a result, banks prefer rationing credit to raising loan interest rates. According to this imperfect information view, a free interest rate regime alone may not be sufficient for allocative efficiency of capital. In such an environment government intervention in the form of financial repression may be preferable to liberalization. Criticizing this conclusion, Fry (1997, p.760) notes that there is “such a small range of real interest rates over which financial repression could be appropriate, if it is appropriate at all.” Moreover, Fry (op. cit.) appears to agree with Arestis and Demetriades (1997) in their contention that “market failure does not necessarily imply government success....(T)he effects of financial liberalization depend upon the institutional context of the economy in question and, particularly, the existence or otherwise of good governance” (p.796), a view that ironically does not exclude the possibility of credit rationing.

Empirical literature testing the relationship between financial liberalization (or one dimension of it) and growth is quite sizable. The findings, however, are mixed and inconclusive. The general agreement is that a higher level of financial sector development is associated with a higher rate of economic growth (see, for example, Beck et al, 2000 among many). However, the experiences of various countries reveal that financial liberalization may be neither a necessary nor a sufficient condition for achieving a high growth rate. Indeed, there may be “reverse causation” too: it could very well be the case that faster growing economies are more likely to choose to liberalize their economies, rather than financial liberalization causing economic growth (Arestis and Demetriades, 1997). It is also stressed that there is a need to carefully manage and sequence the integration of an economy with the global market as part of the financial liberalization package. However, sequencing does not appear to be vindicated in empirical work. A recent study concludes that “the ordering of liberalization does not matter in general. Opening the capital account or the stock market does not have a different effect than opening the domestic financial sector. But one exception exists; crashes seem to be larger in emerging markets if the capital account opens up first” (Kaminsky and Schmukler, 2003, p. 31).

Bekaert, Harvey and Lundblad (2000) study emerging equity markets before and after they dropped barriers to foreign participation in equity markets and report that many of them

exhibit higher average growth rates after the official liberalization dates, without making any statements about the cause and effect relationship. After controlling for various factors that contribute to a country's economic performance, the authors find that the effect of liberalization on economic growth is small but still positive at about 0.7 to 1.4 percent and that the effect is stronger in countries with higher levels of secondary school enrollment. In a later study, the same authors find that equity market liberalizations lead, on average, to a one percent increase in annual real per capita GDP growth over a five-year period and that this effect is not spuriously accounted for by macroeconomic reforms or by business cycles (Bekaert, Harvey and Lundblad, 2001). They also find that investment to GDP ratio rises after capital market liberalizations, whereas the consumption to GDP ratio falls, the trade becomes more negative and the size of the government sector remains about the same. Therefore, they disagree that capital flowing in after liberalization is channeled mainly to consumption.

Rodrik (1998) casts doubt on the effect of capital account liberalization on growth. In a sample that includes almost 100 countries, developing as well as developed, he finds no significant effect of capital account liberalization on the percentage change in real income per capita over the period 1975 to 1989. Edwards (2001) finds that the positive relationship between capital account openness and productivity performance only manifests itself after the country in question has reached a certain degree of development. At very low levels of domestic financial development a more open capital account may have a negative effect on performance. Edison et al (2002) find mixed evidence that capital account liberalization promotes long-run economic growth and that the positive effects are most pronounced among countries in East Asia.

Empirical work on financial liberalization and saving gives no support to the financial liberalization hypothesis. Bayoumi (1993) examines the effect of financial deregulation on personal saving in United Kingdom. He finds that household saving showed a decline associated with financial innovation; and that saving became more sensitive to wealth, real interest rates and current income. He attributes a fall of 2.25% in the personal saving rate to deregulation alone. Bandiera et al (2000) find no evidence of positive effect of the real interest rate on saving in eight developing countries. In most cases the relationship is negative. Furthermore, the effect of the financial liberalization index on saving is mixed: negative and significant in some countries, positive and significant in some others.

One possible reason for the ambiguity of findings in the empirical literature on financial liberalization and growth may arise from the difficulty in identifying and quantifying

liberalization in a consistent manner across a wide group of countries. Consequently, different studies have applied different empirical measures. Another reason may be that, while most studies start with essentially the same benchmark cross-country growth model, there is divergence with respect to the set of countries included in the analysis, the sample period that is investigated, the dataset employed, and the estimation technique applied. Another explanation as to why empirical studies do not find the strong effect mentioned in the theoretical papers, is provided by Prasad et al (2003). Most of the differences in income per capita can be explained by differences in “social infrastructure,” i.e. governance, rule of law, respect for property rights etc. If this is the case, then liberalization is unlikely to increase growth by itself. It is also true that there are costly crises that many developing countries have experienced in the process of financial integration. As we will discuss further in this paper, a flawed sequencing of domestic financial liberalization, when accompanied by capital account liberalization, increases the chance of banking or exchange rate crises, which are often accompanied by huge output losses.

### **Economic Growth and Poverty**

We now turn to the discussion of the link between economic growth and poverty. Although economic growth represents increased output for a country in general, there is no guarantee that the gains from growth will be distributed evenly among the various groups. World Bank (2001) puts it very aptly: “For a given rate of growth, the extent of poverty reduction depends on how the distribution of income changes with growth and on initial inequalities in income, assets, and access to opportunities that allow poor people to share in growth.” (p. 52).

Broadly, there are two ways in which economic growth can benefit the poor (Klasen, 2001). First, there are direct benefits in which economic growth favors the sectors and regions where the poor exist, and the factors of production that the poor own. Although policies designed to work through the direct channel appear more reliable in reducing poverty, they carry the risk that the poor will probably suffer more in times of recession. There are also indirect benefits that operate through redistributive policies, especially taxes, transfers and government spending. Economic growth can provide opportunities for redistributing the gains from growth. Growth can generate the fiscal resources to expand investments in the assets of the poor or to expand transfers and safety nets for the poor.

Empirical evidence on the relationship between economic growth and poverty has one clear message: as countries get richer, on average the incidence of income poverty falls.

Furthermore, the poor in developing countries share in the gains from rising aggregate affluence and in the losses from aggregate contraction (Ravallion, 2001, World Bank, 2001). Using a sample of 80 countries covering four decades, Dollar and Kraay (2002) find that the income of poor (i.e. bottom fifth of the population) rises one-for-one with overall growth in per capita GDP. Moreover, they find that contrary to some popular views, the effect of growth on the income of poor is no different in poor countries than in rich ones; and that the poverty-growth relationship has not changed from the 1960s and 1970s to the 1980s and 1990s. An interesting recent study that builds on Dollar and Kraay (op. cit.) attempts to identify the potential sources of pro-poor growth (Kraay, 2004). Three sources are proposed: “(a) a high rate of growth of average incomes; (b) a high sensitivity of poverty to growth in average incomes; and (c) a poverty reducing pattern of growth in relative incomes” (p. 3). Using a large sample of developing countries, it is found that most of the variation in poverty changes is accounted by growth with the remainder due to poverty-reducing patterns of growth in relative incomes.<sup>1</sup> Although in general growth reduces poverty, there is also considerable churning under the aggregate outcomes, for example, some people lose during spells of growth even when poverty goes down on average. Therefore, one has to look “beyond averages” (Ravallion, 2001).

The empirical literature presents different findings on what makes growth pro-poor (i.e. which institutions and policies influence the extent to which growth benefits the poor). One common finding is that inflation has a negative effect on poverty. Dollar and Kraay (2002) test the impact of a set of institutions and policies (that have been identified as pro-growth in the literature) on the income of the poor and find that openness to international trade and improved rule of law raise incomes of the poor by raising overall incomes and that their effects on the distribution of income is very close to zero. Improving fiscal discipline and stabilizing inflation not only raise overall incomes, but they appear to have an additional positive effect on the distribution of income, further increasing incomes of the poor. Easterly and Fischer (2001) use data from an international poll of 31,869 respondents in 38 countries to find that inflation tends to lower both the share of the bottom quintile of the income distribution and the real minimum wage; it also tends to increase poverty. Datt and Ravallion (1999) find evidence that inflation is a significant determinant of poverty using data for Indian states.

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<sup>1</sup> There are differences between Dollar and Kraay (2002) and Kraay (2004) in two respects. The first is that Kraay (op. cit.) focuses on absolute poverty measures, while Dollar and Kraay (op. cit.) concentrate on relative poverty measures. The second difference is that while Dollar and Kraay (op. cit.) look at common summary statistics (i.e. Gini coefficient and quintile shares), Kraay (op. cit.) utilizes measures of distributional change for poverty.

Although there seems to be an agreement in the literature on the negative effects of inflation on poverty, the evidence on the effects of social spending such as health and education is mixed due to different methodologies or samples. Dollar and Kraay (2002) find that public spending on health and education has no systematic effects on incomes of the poor. They attribute this to the inability of governments in many countries to design social services that are well targeted towards the poor. Filmer and Pritchett (1997) also find little relationship between public health spending and health outcomes such as infant mortality, raising questions about whether such spending benefits the poor. In contrast, Bidani and Ravallion (1997) do find a statistically significant impact of health expenditures on the poor (which they define in absolute terms as the share of the population with income below one dollar per day) in a cross-section of 35 developing countries, using a different methodology. Gouyette and Pestieau (1999) find a simple bivariate association between income inequality and social spending in a set of 13 OECD economies.

We have examined in this section so far the strength between financial liberalization and poverty in an indirect way, namely how financial liberalization can affect growth, and whether growth in its turn can affect poverty. There is, however, a noteworthy study (Jalilian and Kirkpatrick, 2002) that attempts to test econometrically the relationship between financial liberalization and poverty through the growth channel in a more direct way. These authors build their work on the assumptions that finance exerts a positive and significant influence on growth and that growth of average income leads to growth of incomes of the poor. They then make an attempt to estimate the contribution that financial development makes to poverty reduction in low-income countries, using panel data for 42 countries, including 26 developing and 16 developed countries.

The authors estimate two equations: a growth and a poverty regression. In the growth regression, they are interested mainly in the coefficient on the financial development indicator, the estimate of which has a positive sign but a low degree of significance. They try a variety of proxies for financial development, including bank deposit money assets over GDP, which is the preferred indicator in Beck et al (2000), and net foreign assets over GDP. They control for primary school enrollment, trade regime, change in the rate of inflation, change in the share of trade in GDP, initial real per capita income, change in manufacturing value added over GDP and public expenditure on education. They also include a developing country dummy to test the

hypothesis that it is developing countries that benefit most from financial development, for which they find positive evidence.

The poverty regression that the authors run is inspired by the work of Dollar and Kraay (2002), which finds that growth has been beneficial for the poor. Here, the growth rate of the incomes of the poor (the lowest quintile) is regressed on the growth rate of the average income in the country. The main finding is that growth benefits the poor at least as much as it benefits the average. Control variables in this regression include the change in the Gini coefficient and the change in the rate of inflation, both of which have negative and significant coefficient estimates, and also the change in government expenditure, initial real income per capita and a developing country dummy variable.

Having run these two regressions, the authors combine the estimates in an equation that expresses the effect of financial development on poverty: the first effect is the indirect (trickle-down) effect, which works through economic growth. The second one is the possible direct effect of financial development on poverty. However, the authors assume that the second effect is zero, on the grounds that the measures of financial development, utilized for the purposes of their study, are correlated with the growth rate of GDP and, therefore, cannot be included separately in the poverty regressions. Consequently, the impact of financial development on poverty is only expressed as the product of two derivatives; the rate of change in the growth of income of the poor with respect to one percent change in the growth of average income of population and the change in growth of average income with respect to a unit change in financial development. The estimation of the two regressions as described above yields an average value of 1 for the first term in the product and 0.4 for the second term. Hence, the authors conclude that one unit change in financial development leads to a 0.4 percent change in the growth rate of the incomes of the poor.

What we learn from the literature on financial liberalization, growth and poverty is that there is more agreement on the existence and strength of the link between economic growth and poverty than that between financial liberalization and economic growth. That financial liberalization brings economic growth is a strong assumption in many cases. The growth and poverty reduction effects of financial liberalization depend on the distributional changes induced by growth and the set of institutions and policies that accompany liberalization.

## THE FINANCIAL CRISES CHANNEL

The positive view about financial liberalization in the tradition of McKinnon (1973) and Shaw (1973) has been clouded by the substantial increase in financial fragility experienced in many countries in the 1980s and 1990s in the aftermath of pursuing financial liberalization policies (see, for example, Arestis and Glickman, 2002). In some countries, banking sector problems started soon after the deregulation of the financial sector (see, for example, Diaz-Alejandro, 1985). Fast growing economies in Latin America and East Asia all of a sudden faced recessions and the booming capital flows faded away. These developments sparked discussions among economists about ways of preventing and alleviating crises. Some criticized financial liberalization policies and suggested putting some limits on capital flows to moderate the boom-bust patterns (see, for instance, Stiglitz, 1999; Arestis and Glickman, 2002). We begin, therefore, this section by first attempting to deal with the issue of the way(s) financial liberalization can lead to financial crises. This is, then, followed by a discussion of how financial crises may affect poverty.

A relatively early contribution on the issue of how financial liberalization can lead to financial crises is the study by McKinnon and Pill (1997), where a simple two-period model of borrowing and investing is employed. It is shown that capital markets could go wrong when uncertainty about payoffs to new investments increases as a country moves from repression to reform. When there is moral hazard in the capital market and international financial flows are unrestricted, with the presence of deposit insurance, banks lend exuberantly, which sends over-optimistic signals to firms about the outcome of the reforms. Thus, overborrowing and overinvestment occur. Savings decline and the current account deficit grows rapidly. If the outcome of the reform turns out to be less favorable than expected, firms have trouble repaying investment loans and this puts the banking system in serious trouble.

Bacchetta and Wincoop (1998) study capital flows in recent years and contend that the wave of financial liberalization and structural reforms is the fundamental factor behind the increase in capital inflows to some developing countries. The authors show that it is possible to reproduce some main features of capital inflows to emerging markets, such as overshooting of asset prices, volatility of financial markets and contagion by using a rather simple model and without relying on irrational or herding behavior. Arestis and Glickman (2002) are also concerned with the impact of financial liberalization on financial crises. They base their

explanation, though, on Minsky's (1986) "financial instability" hypothesis. Arestis and Glickman (2002) extend this hypothesis to the open economy, "liberalized" case, and locate the explanation to the endemic instability of financial markets. High growth and low unemployment are threatened by this instability. Financial liberalization intensifies this threat by acting as the key euphoria-inducing factor. Under financial liberalization, economies are forced to bear a greater degree of "ambient" risk (Gabel, 1995) than otherwise, so that the euphoria promulgated by financial liberalization produces financial crises.

Empirical work on the impact of financial liberalization on macroeconomic volatility and crises provides evidence of an increased likelihood of eventually being hit by financial crises for countries that have gone through financial liberalization.<sup>2</sup> According to Kaminsky and Schmukler (2003), although equity markets stabilize in the long run (i.e. in five years or longer) if financial liberalization persists, the amplitudes of booms and crashes substantially increase in the immediate aftermath of financial liberalization. That is, financial liberalization tends to trigger larger financial cycles. The authors also find that the short-run effects of financial liberalization vary across mature and emerging markets. In emerging markets, the short-run effects are more pronounced. Booms and crashes increase in the immediate aftermath of financial liberalization by about 35 percent over their size during recession. In mature markets, even when financial liberalization triggers more volatile stock markets in the short run, booms and busts do not increase as much as in the case of emerging markets. Moreover, mature markets experience larger bull markets but less pronounced bear markets in the aftermath of financial liberalization, which supports the view that financial liberalization is beneficial for them even in the short run. However, the experience of emerging markets suggests that larger booms and crashes emerge immediately following financial liberalization.

How do financial crises affect poverty? Financial crises, including balance of payments and banking crises, may not only affect the current living standards of the poor, but also their ability to grow out of poverty. There are a variety of channels through which crises affect poverty and income distribution (Baldacci et al, 2002; Ferreira et al, 1999). First, crises typically lead to a fall in earnings of both formal and informal-sector workers due to job losses in the formal sector and a decline in the demand for services in the informal sector. These changes may have different impacts on workers with different skills and different levels of job security.

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<sup>2</sup> The term "financial crisis," as used in the text, denotes either a banking crisis, a debt crisis or a foreign exchange market crisis.



Second, changes in relative prices caused by a crisis will have some effects on the distribution of income. Currency depreciation leads to a decline in the price of non-tradeables relative to tradeables, leading to a fall in the earnings of those working in the non-tradeables sector. If an increase in demand for exports follows the currency depreciation, then higher employment and earnings in the exporting sectors may follow, which offsets some of the income loss. However, if food is imported, then the exchange rate change will hurt the households that are net consumers of food. Thirdly, contractionary fiscal policy that is traditionally implemented in response to a crisis leads to cuts in social programs. This may limit the access of the poor to some essential services at a time when their incomes are falling. Fourthly, changes in interest rates as well as changes in asset and property prices affect different sections of the income distribution differently. Especially higher interest rates, which are normally associated with financial liberalization, have significant redistributive effects that affect the poor harshly, but reward the rich handsomely.

Additional reasons why crises may affect the poor more include the “labor hoarding” hypothesis, highlighted by Agenor (2002) and the asymmetric effects of increased rate of inflation on the poor. The “labor hoarding” hypothesis indicates that unskilled workers (typically poor people) are often the first to lose their jobs as firms “hoard” their trained labor force. This is related to the existence of high costs of hiring, training and firing skilled labor and the more the shock is perceived to be temporary, the greater the incentive to “hoard” skilled workers. The increased rate of inflation that tends to accompany the shocks and their resolution may also affect the rich and the poor differently (Easterly and Fischer, 2001). As the poor normally hold a greater proportion of their wealth in cash than the non-poor, they tend to be more affected by the increased rate of inflation (which is a tax on money holding). Also, as nominal wages are not perfectly linked to the price index, inflation leads to a decline in real wages. This affects the poor more than the rich because poor people do not have capital rents. Moreover, labor earnings constitute a much larger share of their total income.

There are also reasons, which relate specifically to the Latin American countries. Lustig (2000) shows that crises not only result in higher poverty rates but also may cause irreversible damage to the human capital of the poor. In Latin America, the poor are vulnerable to negative shocks for a variety of reasons. They have little or no access to public social insurance schemes because they are largely either self-employed or unpaid family workers. Even when they are wage earners, they often work for employers who have difficulties in complying or are

unwilling to pay their share in a contributory system. Since enforcement mechanisms tend to be weak for smaller and micro firms, non-compliance can be large. Also, the poor may be precluded from access to social insurance because of legal restrictions, such as is the case with domestic workers.

Most of the empirical evidence on the effects of crises on poverty supports the argument that crises have an aggravating effect on poverty. Lustig (2000) shows that out of 20 crises in Latin America, all were followed by an increase in the poverty headcount ratio, and 15 of them by a rise in the Gini coefficient. Baldacci et al (2002) estimate the impact of financial crises on the incidence of poverty and find that both macro and micro data show an increase in poverty due to a financial crisis. Studying the particular case of Mexico, they find that poverty rates soared and the poverty gap widened, relative to pre-crisis period, due to increase in formal unemployment, notably in urban areas, and the insufficient adjustment of the level of social safety net in a period of rising inflation. In contrast, Dollar and Kraay (2002) discard the idea that crises are particularly hard on the poor. Defining a crisis as an episode of negative per capita GDP growth of at least five years, they find that income of the poor (i.e. the poorest one fifth of the population) do not decline more than the mean income does in crisis episodes. Yet, they acknowledge that the same proportional decline in income could have a greater impact on the poor if the safety nets are weak, thus making crises harder on the poor. Levinsohn et al (1999) find that the poor in Indonesia have been hit the hardest by the dramatic price increases that resulted from the recent financial crisis. Therefore, the notion that the very poor are insulated from international shocks is not right, at least in the Indonesian case.

One may generalize the state of current evidence on this issue by suggesting that financial liberalization can affect a country's vulnerability to financial crises, which is likely to hurt the poor disproportionately. The challenge for policymakers, then, is primarily to take appropriate measures to avoid crisis situations if the decision to liberalize the financial sector has already been made. The roles of exchange rate policy, capital controls and counter-cyclical fiscal policy in generating or avoiding crises should be seriously taken into consideration. It is equally important to choose pro-poor responses to crises in case they cannot be avoided. The incomes of the poor should be protected in the face of macroeconomic adjustment by using appropriate policy options, such as by maintaining safety nets and by carefully selecting the composition of fiscal adjustment.

## **THE ACCESS TO CREDIT AND FINANCIAL SERVICES CHANNEL**

The financial liberalization process may have some profound effects on the availability of credit and financial services for the poor. The proponents of financial liberalization argue that it leads to financial deepening and better access to credit for previously marginalized borrowers and savers. Reduction of reserve requirements increases the supply of credit for a given level of deposits. A rise in the rate of interest increases savings and bank deposits thereby allowing banks to supply more loans. Furthermore, the removal of barriers to entry increases competition among the providers of financial intermediation and motivates banks to extend their services to traditionally excluded sections of the population (Chigumira and Masiyandima, 2003). This opens up new financial options for savers and borrowers. Bayoumi (1993) finds that the saving function of households in the United Kingdom changed noticeably as a result of widespread domestic financial deregulation, however the effects on the poor are not investigated. Nonetheless, it is not clear that financial sector reforms will increase the supply of loans to small firms and the poor. As noted by Chigumira and Masiyandima (2003), from the banks' point of view, it is generally more costly to lend to the poor than to large and established companies, due to higher processing, administrative and monitoring costs and higher risk of default. One fundamental distinction between conventional banks and development financial institutions is that bank lending emphasizes profitability rather than other lending criteria such as the viability of the project or social outreach. Thus, banks may naturally prefer doing business with established companies rather than providing loans to the poor even after financial sector reforms.

The poor in developing and transition countries may be offered little or no financial services or access to credit for a number of reasons (Holden and Prokopenko, 2001). First, the demand for deposit facilities may be low, due to macroeconomic instability or deficiencies in the regulation and supervision of financial institutions. Also, the supply of saving facilities may not be adequate due to high fixed costs or low economies of scale associated with opening bank branches, especially in rural areas. Second, credit risk assessment may be difficult in developing countries, due to either macroeconomic instability, poor accounting practices that distort the real financial situation of borrowers or inadequate management of the financial institution itself. It may also be that the lack of a strong judicial system and difficulties in bankruptcy procedures, limit the lenders' ability to obtain repayment of their loans. The third reason may be due to the

regulation and supervision of financial institutions. In some countries, extremely liberal licensing policies lead to a large number of weak institutions. In other countries, very restrictive requirements reduce competition and increase the power of existing institutions, resulting in a widening of the spread between lending and deposit rates. Furthermore, inadequate regulation of conduct may effectively tolerate insider lending, thus increasing the credit risk exposure of the financial system.

The impact of financial liberalization on the availability and allocation of credit to the poor could also work through the effect of liberalization on the interaction between formal and informal financial markets. In fact, thinking of developing countries, one cannot possibly ignore the formal and informal market interaction, since the informal financial sector has usually a more important role in these countries and paying attention only to the formal sector will be misleading. The point, however, to make is that financial liberalization that expands the formal sector at the detriment of the informal sector, can hurt the poor in a big way in view of the fact that the poor operate mainly in the informal sector. The point needs further elaboration.

Lensink (1996) argues that financial liberalization of the formal sector may lead to a decline in savings and hence in the quantity of investment by reducing the overall allocative efficiency of capital. He observes that in a number of sub-Saharan African countries savings and the efficiency of investments failed to improve following financial reform programs that focused strongly on the formal banking sector. What the liberalization program failed to recognize is that the formal banking sector in sub-Saharan Africa is relatively unimportant for the financing of investment projects. The bulk of the population makes little or no use of the formal savings and lending institutions. In contrast, a flourishing informal financial sector exists. Moreover, information problems (imperfect information, moral hazard and enforcement problems) can be severe in the formal financial sector. The lenders in the informal sector solve these problems by lending to a particular group of clients with whom they usually work and live in the same village. Since the informal lender has better knowledge of the borrower than the formal lender, it has better opportunities to discriminate among borrowers with high and low risks and is better able to charge appropriate interest rates. This informational advantage applies particularly to rural investment projects, since in rural areas only a few formal banks exist. In such an environment, financial liberalization can shift funds from the better informed informal to the poorly informed formal sector. This will reduce the overall efficiency of capital allocation process. Therefore, a financial liberalization program that ignores the existence of the informal

sector may eventually lead to a worsening of resource allocation and investment quality (Lensink, 1996). Obviously, the poor will not be the winners.

Floro and Ray (1997) discuss the complex links between formal and informal financial institutions in developing countries. The lack of information about borrower characteristics, collateral requirements etc. in the formal credit sector constrains its ability to meet effectively the credit needs of small enterprises, who turn to informal credit sector. Informal financial institutions usually operate both in rural and urban areas, representing a major source of credit for many borrowers. One way of interaction between the two is horizontal: individuals first try the formal market; excess demand spills over to the informal market. The other is vertical: informal lenders have access to formal sources of lending; they re-lend the funds they borrow from the formal market. In the case of vertical integration, one question is whether the terms of credit for informal borrowers will improve when an expansion in formal credit is created, possible via government intervention (for example in the form of targeted loan policies at below market interest rates).

The authors claim that the answer to this question depends on the market structure of the informal credit system. In the case of the Philippines, they argue that there is evidence of noncompetitive behavior among rice millers (the highest rank of the informal credit hierarchy) supported by accounts of comprehensive information sharing, collective monitoring, price setting and substantial capital requirements that set barriers to entry. Rice millers lend funds to traders in the form of cash advances for buying the output of rice farmers. The authors observe that millers have some influence on the terms offered to the farmers by the traders, i.e. that the effect of noncompetitive behavior among the millers is transmitted down the ladder. The kind of noncompetitive market structure envisioned by the authors is collusive behavior in a repeated game setting. Each rice miller (lender) has a particular niche of borrowers; therefore each has an incentive to undercut activities of another lender in his niche. These incentives are balanced by a threat of a credit war in which deviant lenders are punished by a retaliatory expansion of credit in their territory. The greater the access to credit of lenders, the bigger the threat and the easier it may be to sustain collusion. In such an environment, an expansion of formal credit to informal lenders may not be used but held only as a potential threat, facilitating collusion. Therefore, credit expansion by the formal sector to rice millers, for instance, as part of a financial reform package, does not necessarily increase the availability or improve the terms of credit to small farmers and the poor in more general terms. In any case, under the conditions examined in both

the Lensink (1996) and the Floro and Ray (1997) studies, the nature of the interaction between the formal and informal financial sectors has to be kept in mind when designing liberalization programs.

Empirical research on whether financial liberalization improves access to credit by the poor and the marginalized is so far rather limited. The findings are usually not very optimistic. The results from Euler equation estimations by Bandiera et al (2000) suggest that financial liberalization has had little impact on the availability of credit to consumers through the formal financial sector in eight developing countries: Chile, Ghana, Indonesia, Korea, Malaysia, Mexico, Turkey and Zimbabwe. Chigumira and Masiyandima (2003) report that in Zimbabwe financial sector reforms implemented beginning in 1991 had some positive effects. Removal of controls on interest rates and credit along with easing of financial sector entry restrictions resulted in increased financial depth as entry into the financial sector went up and a wider variety of financial products became available for the majority of the population. After the early years of reform, real incomes increased, leading to higher savings. Both total domestic credit and private credit increased. However, high and unstable inflation starting from the late 1990s dampened savings as savers tended to switch back to physical inflation hedges as opposed to financial savings. Further problems were also evident in Zimbabwe. Chigumira and Masiyandima (2003) suggest that “Much of the increase in the private sector credit was mainly for established borrowers as opposed to the small and medium scale enterprises (SMEs), which got on average less than 5% of the total domestic credit supply even if their proportion of savings in the economy’s total financial savings is high” (p. 52). Two main reasons were put forward to explain that experience. First, banks continued to use conventional lending methodologies, which focus on collateral security, capacity, character of borrower, initial capital outlay and business track record, which commonly lack among the SMEs and the poor. Second, the implementation of reforms in an unstable macroeconomic environment led to high lending rates. With high and uncertain inflation rates, nominal interest rates were pushed to significantly high levels, even though real interest rates were low. The excessive lending rates discouraged SMEs and the poor from borrowing. Amonoo et.al. (2003) provide some evidence on the effects of financial liberalization in Ghana. Specifically, they study how rises in interest rates that come with the adoption of financial liberalization affect the demand for credit and loan repayment by the poor and the SMEs in a rural region of Ghana. They find a negative relationship for both

cases. Hence, they infer that lowering interest rates would increase the demand by the poor and SMEs for credit and loan repayment at banks and non-bank institutions.

Consequently, available evidence suggests that financial liberalization can have consequences for access to the financial market by small customers and the poor. Whether these consequences are adverse or beneficial is far from clear. On the one hand, increased competition and improved distributional efficiency will lead financial institutions to seek markets normally rationed out, i.e. small borrowers with good business prospects and insufficient collateral. In doing so they may extend financial services to a larger share of the population and contribute to financial innovation. On the other hand, financial sector reforms may also leave the basic structure of the banking system unchanged, thereby protecting or reinforcing the oligopolistic position of banks. In this case, the customers usually excluded from financial transactions will not benefit from greater access. Some marginal customers may even be excluded.

In many countries, financial sector reforms so far have not embraced the broad agenda of developing the institutional structure and new instruments to satisfy the financial needs of small enterprises and the poor. The focus has mainly been on liberalizing interest rates and encouraging entry into the formal financial institutions. These are not sufficient to improve access to credit and financial services by the poor, given the empirical evidence on the experience of some developing countries with financial liberalization.

Even if credit and financial services are extended to small customers and the poor, it is unlikely that improved access by itself will eradicate poverty. “Alleviating poverty through banking is an old idea with a checkered past. Poverty alleviation through the provision of subsidized credit was a centerpiece of many countries' development strategies from the early 1950s through the 1980s, but these experiences were nearly all disasters” (Morduch, 1999). Therefore, although the highly motivated and entrepreneurial candidates probably use the new set of opportunities well and benefit from access to credit, those who lack the skills or the determination to manage their finances are destined to end up in bankruptcy.

### **Policies to Enhance Access to Credit by the Poor**

If the financial liberalization process by itself does not improve the access to credit and financial services by the poor, then policy makers should satisfy some requirements to make sure financial services are more readily available to all segments of the society. Holden and Prokopenko (2001) emphasize that the first requirement is the establishment of macroeconomic

stability, yet it is not a sufficient condition. Another requirement is establishing a basis for adequate regulation and supervision of financial institutions. Unless constrained by regulation, the managers of financial institutions may not have sufficient incentives to keep risk within acceptable limits. Effective regulation and supervision may be especially important in developing and transition countries because of a greater need for building public confidence in the financial system. However, excessive constraints on financial institutions may increase the costs of operating in some areas and, therefore, may reduce the probability of promoting financial services to the poor.

Holden and Prokopenko (2001) also mention the need for financial institutions that are specialized in certain industries or certain types of lending, such as factoring and leasing companies or mortgage finance companies. They argue that these institutions are in a better position than large multi-purpose institutions to assess financial and investment plans in their field of expertise. They can help small and medium size enterprises with their financing needs in cases where commercial banks that dominate the financial sector lend only to large and well-established firms.

To alleviate credit risk assessment problems, financial institutions in developing and transition countries may also consider using some simple credit scoring models (Holden and Prokopenko, 2001). In cases where poor accounting records prevent these institutions from using traditional methods of credit assessment, these simple models can work well enough to satisfy the need. Along similar lines, the authors also recommend establishing credit information bureaus (centralized databases that include financial information on enterprises), which can help reduce financial constraints resulting from underdeveloped financial markets. They also recommend strengthening property rights in developing and transition countries. Effective and secure property rights allow the development of financial markets by reducing adverse selection and moral hazard problems. Chigumira and Masiyandima (2003) recommend that the lending criteria of conventional financial institutions be revised to make them more appropriate for micro-borrowers. New approaches, such as the use of solidarity groups, village banking or group lending where group members guarantee each other, can be implemented. Such risk-sharing schemes may encourage banks to lend to the poor at low cost, low risk and without any form of traditional collateral.

Last, but not the least, the role of microfinance institutions should be emphasized. These institutions have the advantage of proximity to the market they serve and, therefore, enjoy better



knowledge of the community. They complement the formal financial system by providing services to the parts of the society that have limited access to the formal system (Holden and Prokopenko, 2001). Chigumira and Masiyandima (2003) report that the emergence of micro-finance institutions in the late 1990s in Zimbabwe helped narrow the loan gap of the poor. Due to their more appropriate and effective lending methodologies and their strategic locations, these institutions have managed to service the poor and the SMEs with more success than conventional banks. The authors maintain that the promotion of linkages between the formal and informal financial institutions would facilitate the design of diversified savings instruments that take into account the investment needs of the poor. The authors would like to see a consolidation of micro-finance institutions into the conventional banking sector by regulating these institutions and allowing them to collect savings as well as provide credit.

## **SUMMARY AND CONCLUSIONS**

The experience with financial liberalization in the past two decades has shown that the process has a complex relationship with respect to changes in the living standards of the poor. It is usually assumed in the literature that an economic expansion brought about by the liberalization of interest rates, removal of barriers to entry to financial markets, opening up borders to capital flows and letting markets determine exchange rates will eventually benefit the poor via a trickle-down effect. Evidence tells us that this is not always the case. Although financial repression may not be desirable, its alternative is not traditional liberalization. When financial liberalization is applied without first maintaining macroeconomic stability and establishing the supporting institutions and policies, even when it brings economic expansion, it often comes at the cost of devastating crises and increasing economic inequality. Without adequate regulation and supervision, financial institutions may take excessive risks. The poor appear to pay a higher price than the rich in the aftermath of these crises.

It is important to provide the poor with sufficient access to consumption smoothing mechanisms to alleviate poverty. For this purpose, various measures have to be taken. Revising the credit evaluation and lending criteria of financial institutions to make them more appropriate for small-scale borrowers is one such measure. Setting the legal and institutional framework for alternative lending practices, such as group lending, is another one. Equally important as providing access to credit and financial services is providing the poor with education, safety nets

and basic health services. Unless they are equipped with the proper skills to take advantage of the financial services and to manage the debt, the poor may not benefit at all from the new set of prospects.

The core of the discussion is that if financial liberalization were to be introduced, it must be designed with poverty reduction as its thrust in order to benefit the poor. Otherwise, the market by its nature will benefit those who already have access to economic resources or to information and those who are strategically positioned to take advantage of the opportunities offered by the market.

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<sup>3</sup> IFLIP (the Impact of Financial Sector Liberalization on the Poor) is a research-capacity building program coordinated by the ILO. It aims to contribute to the debate on financial liberalization by generating active research on the effects of financial sector reforms in selected African countries, currently Benin, Ghana, Senegal and Zimbabwe and by integrating research findings into policy making at national and regional levels.

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