Financial Policies for Pro-Poor Growth: A Training Manual

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**Economic Policies for Growth, Employment and Poverty Reduction**
Training Module:

Financial Policies for Pro-Poor Growth

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1. A Pro-Poor Growth Approach to Financial Policy: Introduction

This module describes the current state of knowledge with respect to pro-poor growth financial policies. These policies are presented as alternatives to what we argue are the failed financial policies inspired by orthodox economics. Orthodox financial policies, also known as "Washington Consensus" policies, have been implemented in a large number of developing countries over the last quarter century. We explore the logic of these financial policies and examine the diverse ways in which they have failed the developing world.

The principal goals of this module are to present a range of financial policies that have been utilized in some countries to promote pro-poor growth at various times, and also to present a set of more innovative policies that have not yet been utilized, but which we argue can also support pro-poor growth. We argue, in fact, that there exists a wealth of such experiences and strategies available to practitioners in the developing world.

1.1 A Brief Review of Historical Experience

If the 1950s and 1960s were the "golden age" of capitalism in the industrialized world, then in much of the developing world, this period should be remembered as the age of the "developmental state" [Marglin and Schor, 1990; Wade, 1990; Amsden, 2001]. In many parts of the developing world, especially those that had recently won independence from colonial powers, the state was seen as a general agent of economic development. Its prescribed tasks included mobilizing and directing savings for industrialization, using industrial and trade policy (including tariffs) to guide investment and industrial development, implementing financial market regulations (including capital and exchange controls) to marshal domestic and international financial resources for domestic investment and to manage the country's relations with the international markets, and using government ownership of some financial and industrial firms to control the rate and direction of investment and generate employment and to address various social problems, such as poverty [e.g., Nembhard, 1996; Woo-Cumings, 1999]. Many developing countries, such as India, Brazil, Argentina, Taiwan POC, South Korea, Singapore, South Africa, and Ghana, used diverse types of policies to industrialize and to promote economic growth and improvements in living standards.

In the area of finance, many developing country states were especially active. These countries were taking a leaf from Alexander Gerschenkron's famous thesis that "late developers" had to make use of special financial institutions to mobilize and channel savings for long-term investment and growth because of the scale and complexity involved in catching up to global leaders [Gerschenkron, 1962]. Moreover, significant involvement by the state in the area of finance was in keeping with the general tenor of the times, which had perceived the calamitous role of private finance in the disastrous collapse of the world economy in the 1930's [Helleiner, 1994; Kindleberger, 1973]. During this period, a variety of state-owned, state-regulated, or state-directed financial institutions were created to mobilize and channel credit to agricultural and industrial...
sectors of the economy, as well as to important social sectors such as housing and education.

Significantly, these policies of state management and direction of finance were used widely not only in many developing countries, but also in the developed world [Zysman, 1983]. In countries with economic systems as diverse as those in Japan, France, the United States and Germany, financial regulations and state-owned or directed banks were used for a range of economic and social purposes, including subsidizing housing, supporting industrial policy and export promotion, promoting small businesses and financing infrastructure development [Pollin, 1995; Grabel, 1997; Epstein, 2006].

In the era of the developmental state, central banks in developing countries often cooperated with or were under the control of governments. These “developmental central banks” supported the state's developmental goals through a variety of tools and mechanisms, including subsidizing credit, and regulating financial institutions to direct credit to specific purposes [Bloomfield, 1957; Brimmer, 1971]. In fact, as a marker of the times, many of these developmental central banks were established with the help and advice of the New York Federal Reserve, which today would arguably have no part of such advice [Helleiner, 2003]. This type of central bank practice, of course, contrasts rather radically with today’s orthodox vision of central banks, institutions that are exorted to be politically independent of governments, and to focus primarily, if not exclusively, on keeping inflation in the low single digits.

As prominent Federal Reserve Economist and historian Arthur Bloomfield noted:

“Many of the central banks, especially those established since 1945 with the help of Federal Reserve advisers (emphasis added) are characterized by unusually wide and flexible powers. A large number of instruments of general and selective credit control, some of a novel character, are provided for. Powers are given to the central bank to engage in a wide range of credit operations with commercial banks and in some cases with other financial institutions…..These and other powers were specifically provided in the hope of enabling the central banks…to pursue a more purposive (emphasis added) and effective monetary possible than had been possible for most….that had been set up …during the twenties and thirties… which permitted little scope for a monetary policy designed to promote economic development and internal stability (emphasis added)…” [Bloomfield, 1957 p. 191].

It was a sign of the times, then, that even the US Federal Reserve System was helping developing countries create developmental central banks.

As we discuss in the next section, the post-war vision of developmental central banking and financial policies in the service of pro-poor growth fell out of fashion as part of the general reassertion of orthodox economic theory and policy in the mid-to-late 1970s. In the financial arena, the reassertion of orthodox economics was embodied in the adoption of policies of internal and external financial liberalization and the creation of independent
central banks and the use of inflation targeting [on the latter, see Saad Filho, 2006; Epstein, 2002, 2005]. We will see that these orthodox policies have been associated with reductions in inflation relative to its high levels in the 1980's. But these same policies have also been associated with serious pathologies: recurrent financial crises (eg., in Turkey in 1992, Mexico in 1994, in East Asia in 1997, and in Argentina in 2001); major increases in domestic and by some measures, global inequality [Milanovic, 2005]; slower economic growth and even stagnation in some parts of the world, particularly in Sub-Saharan Africa; and increases in unemployment or underemployment in many parts of the developing world. In view of these failures, the time is ripe to consider new approaches to domestic, central bank and external financial policies.

1.2 Principles of Pro-Poor Growth Financial Policies

Before we consider policy alternatives, we have to answer the following question: What do we mean by pro-poor growth financial policies? At one level, this is quite easy to answer. We will describe policies and institutions that are designed to mobilize and channel savings, allocate credit in accordance with identified social and economic objectives, and promote financial and macroeconomic stability with the goal of promoting growth that will generate employment, income and wealth for the poor.

To achieve these outcomes, financial policies have to serve both general purposes, as well as achieve outcomes quite specific to the needs of particular countries and regions. More specifically, the financial sector can play an important and productive role in promoting pro-poor growth through the following channels. It can:

- Mobilize savings that can be used for productive investment and employment creation;
- Create credit for employment generation and poverty reduction at modest and stable real interest rates;
- Allocate credit for employment generation and help the poor to build assets, including in agriculture and in small- and medium-sized enterprises and in housing;
- Provide patient (long-term) credit for productivity-enhancing innovation and investment;
- Provide financing for public investment to provide for employment generation and productivity enhancement;
- Help to allocate risks to those who can most easily and efficiently bear those risks;
- Help to stabilize the economy by reducing vulnerability to financial crises, procyclical movements in finance, and by helping to maintain moderate rates of inflation;
- Help the poor by providing basic financial and banking services.
1.3 Goals and Organization of the Module

It is the chief goal of this module to describe how diverse parts of the financial sector (namely, the domestic and external sector and the central bank) can play the roles described above. In section 2 of this module we describe the logic and the (failed) performance of the financial policies inspired by orthodox economic theory. In section 3 we present a snapshot of the rather problematic state of the financial environment in developing countries today. Sections 4-6 are the heart of this module insofar as these sections present a range of financial policies that can be used to promote pro-poor growth. Section 4 presents policies for the domestic financial sector, section 5 policies for developmental central banks, and section 6 policies toward external financial flows.

2. Orthodox Approaches to Financial Policy in Developing Countries

Having made a case for pro-poor financial policy above, we now consider an alternative logic that we term the orthodox view. The orthodox view has driven the financial policy decisions made in most (but not all) developing and wealthy countries over the last quarter century. There are many reasons for the shift toward orthodox financial policies. These include advocacy on the part of the US and UK governments and the Bretton Woods and other multilateral institutions; widespread acceptance of orthodox economic theory; increased power and autonomy of the financial sector globally and nationally; and the attempt by policymakers in developing countries to use open financial markets as a magnet for international capital flows.

In this section, we explain the theoretical basis of the orthodox case for liberalization (i.e., deregulation) of the domestic financial sector and international capital flows. We discuss these two dimensions of liberalization separately for the sake of clarity in sections 2.1 and 2.2, respectively, though in practice they are often treated together. Note that the reduction of poverty is not central to the orthodox case for financial liberalization. But liberalization is nevertheless seen to benefit the poor through numerous channels. In section 2.3 we briefly review the performance of the financial reforms inspired by the orthodox view. We will see that this policy has failed to achieve its chief goals, and it has aggravated important problems (such as poverty, inequality, and instability). These failures stand in sharp contrast to the limited successes that can be attributed to financial liberalization, as we will see.

2.1 The Orthodox Case for Liberalization of the Domestic Financial Sector

Orthodox economists maintain that the state regulation of domestic finance that was the norm from the end of WWII until the mid-to-late 1970s was counterproductive. These policies are seen as counterproductive today in those few developing countries that maintain a commitment to active state involvement in finance. Orthodox economists use the ideologically-charged term “financial repression” to describe financial systems that are actively regulated in accordance with a state’s development goals. Such systems tend

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1 The discussion in sections 2.1-2.3 draws heavily on Chang and Grabel [2004, chs. 9-10]. Section 2.1 also draws on Grabel [1995] and section 2.2 of Grabel [2003a].
to be dominated by banks whose decisions are influenced by governments, rather than by capital (i.e., stock and bond) markets.

In the orthodox view, active state involvement in the financial sector has a number of adverse consequences. The maintenance of low interest rates (particularly in the context of high inflation) encourages domestic savers to hold funds abroad, and makes current consumption more attractive than saving in domestic financial institutions. High levels of consumer spending can put upward pressure on prices, and thereby aggravate inflationary pressures. Low savings rates also mean that domestic banks have an insufficient pool of savings from which to extend loans. Thus, the level of domestic investment is compromised by active financial regulation, and employment and economic growth suffer accordingly. It is through employment, growth and price channels that orthodox economists maintain that state involvement in finance negatively affect living standards and poverty.

Furthermore, orthodox economists maintain that active state involvement in finance fragments domestic financial markets, with only a small segment of politically-connected borrowers gaining access to scarce low-cost credit. Disenfranchised borrowers must resort to unregulated, “informal” (or “curb”) lenders who often charge exorbitant interest rates, or otherwise have to manage in the face of unmet needs for capital. Entrepreneurship, employment-creation, and growth thereby suffer. These negative effects are disproportionately experienced by the poor as the burden of scarce credit hits them hardest since they rarely have access to alternative, lower-cost sources of credit, such as the finance available on international capital markets.

In view of the above, orthodox economists argue that developing countries must liberalize their domestic financial systems. A liberalized financial system with a competitive capital market is seen as central to the promotion of high levels of savings, investment, employment, productivity, foreign capital inflows, and growth. From this perspective, liberalized systems serve the interests of the poor and the disenfranchised (as well as other groups) by increasing access to capital with attendant benefits for employment, investment and growth.

Orthodox economists maintain that domestic financial liberalization not only increases the level of investment, but also increases its quality (i.e., its efficiency) by allocating funds across investment projects according to rate-of-return criteria and via what are seen as objective or “arms-length” practices. Domestic financial liberalization is seen to improve the overall efficiency of the financial system by eliminating the wasteful and corrupt practices that flourish under financial regulation, and by subjecting borrowers and firm managers to market discipline. Market discipline and a reduction in corruption improve the operating performance of financial institutions, and consequently enhance the prospects for financial stability.

In the orthodox view, liberalization has other benefits. It encourages the creation of new financial instruments (e.g., derivatives) and markets in which to trade them. This is termed financial innovation. Investment and financial stability are promoted by new
opportunities to diversify and disperse risk. By increasing the availability of finance, liberalization also eliminates the need for informal finance that often exploits the poor, and allows borrowers to utilize forms of finance that are most appropriate to their investment project.

Orthodox economists see the finance provided through capital markets as preferable to bank loans because the former is understood to have a greater ability to disperse risk, is allocated according to objective efficiency and performance criteria, is cheaper than other forms of external finance (such as bank loans), and is highly liquid. The liquidity attribute is seen as especially desirable because it places firm managers under the threat of investor exit (or higher capital costs) if they under-perform. (See section 2.2 for further discussion.) The promotion of internationally-integrated capital markets has the added benefit of facilitating the rapid integration of developing countries into the global financial system.

Some orthodox economists argue that full domestic financial liberalization can be attained only once other sectors of the economy (such as tradeable goods, labor markets) are well functioning and liberalized. This is known as the sequencing view. However, many orthodox economists reject arguments for sequencing because of the problems introduced by this strategy (such as the possibility that it gives time for interest groups to mobilize to block liberalization). Despite the debate about the speed or order of liberalization among some orthodox economists, there is no dispute among them that a liberalized domestic financial sector is the ideal to be attained by developing countries.

2.2 The Orthodox Case for Liberalization of International Capital Flows

In the orthodox view, there are numerous benefits associated with unfettered international private capital flows. Open capital markets give the public and private sector access to capital and other resources (such as technology) that are not being generated domestically. Sufficient capital and other resources are not generated domestically because of low income, savings, and growth and capital flight. Thus, orthodox economists maintain that an increase in private capital inflows will inaugurate a virtuous cycle by increasing the nation’s capital stock, productivity, investment, economic and employment growth. All of these benefits redound to the benefit of society as a whole. But the poor may benefit particularly because higher levels of investment increase overall employment opportunities, especially in the modern, technologically-advanced firms that are financed by foreign investment. Sales of government bonds to foreign investors increase the resources available for public expenditure since these are rather scant thanks to problems with tax collection and the myriad demands on budgets. The poor may benefit if new spending is oriented towards them.

Orthodox economists also argue that international private capital flows increase efficiency and policy discipline. The need to attract private capital flows and the threat of capital flight (by domestic and foreign investors) are powerful incentives for the government and firms to maintain international standards for “good policy,” macroeconomic performance, and corporate governance. Specifically, orthodox
economists maintain that governments seeking to attract international private capital flows are more likely to pursue anti-inflationary policies and anti-corruption measures because foreign investors value price stability, transparency, and the rule of law. The poor benefit from stable prices and transparency since they are less able than the rich to hedge against inflation or extract benefits from corrupt regimes.

Liberalization of international capital flows means that a greater proportion of total financial flows will be allocated by capital markets or foreign banks that are not influenced by developing country governments. In the orthodox view, this shift in the allocation mechanism increases efficiency and ensures that finance is directed towards projects that promise the greatest net contribution to social welfare. These are the projects promising the highest rates of return. Here, too, there is an assumed benefit to the poor as they stand equal to the rich and the politically-connected in the competition for capital in internationally-integrated markets.

For the reasons advanced above, orthodox economists hold that liberalization of capital flows is essential to promote sound economic performance, particularly with regard to investment, income and growth. Indeed, had the East Asian financial crisis of 1997-98 not intervened, the IMF was poised to modify Article 6 of its Articles of Agreement to make the liberalization of international private capital flows a central purpose of the Fund and to extend its jurisdiction to capital movements.

As with domestic financial liberalization, some orthodox economists argue that the liberalization of international capital flows (especially the most liquid of these) should be undertaken only after successful liberalization of other sectors or the attainment of sufficient institutional and regulatory capacity. Advocates of sequencing generally find their case strengthened following financial crises, as these are seen as a consequence of premature external financial liberalization. Notably, following the East Asian crisis, some studies, even by IMF staff, acknowledged that certain techniques to manage international capital flows can prevent undue financial volatility, provided that capital management techniques are temporary and that the rest of the economy is liberalized [e.g., Prasad, Rogoff, Wei, Kose, 2003; Kuczynski and Williamson, 2003]. Note that even among advocates of sequencing, there is no question that complete liberalization is the ultimate goal for all developing countries.

2.3 The Performance of Liberalized Financial Systems in Developing Countries

Financial liberalization has been the norm in developing countries over the last quarter century. The policy has had a few successes and numerous unambiguous failures.

On the positive side of the balance sheet, liberalization has furthered the integration of developing countries into global markets. This has meant that some large firms, especially in the context of privatization programs, have received significant finance through the internationally-integrated capital markets created or expanded following financial liberalization. The finance provided to these firms has often been cheaper than that available via bank loans. Counterfactually, it is at least plausible to assume that
levels of investment in firms that gained access to new pools of finance are probably higher than they would have otherwise been absent liberalization. Financial liberalization has meant that governments have been able to raise (i.e., borrow) funds on international capital markets. Middle-class consumers may also have benefited from access to international credit markets, and from the opportunity to diversify their portfolios internationally. Finally, the higher interest rates associated with financial liberalization and the adoption of inflation targeting programs has helped to lower rates of inflation in developing countries.)

However, even these achievements are not without complication. The growth of large firms (and the contraction of small firms that cannot afford to borrow at high interest rates) has increased business concentration. The lower-cost capital that is available to some large firms after financial liberalization has fueled speculative bubbles in many countries. Moreover, capital markets reinforce rather than undermine existing dualisms in regards to access to lower-cost external finance by large firms. There is no evidence that the growth of capital markets increases access to or lowers the cost of finance for those entrepreneurs that have long confronted severe capital constraints. Indeed, as McKinley notes, following financial liberalization, commercial banks have concentrated their activities in major urban areas of developing countries. He goes onto explain that “although aggregate statistics of financial deepening might have improved following financial liberalization, access to credit has become, if anything, more unequal. The rural population remains deprived of credit in most countries, and is likely worse off compared to the access to credit that state-owned agricultural banks had previously provided” [p. 21]. McKinley [2005:23] concludes that, in the African case, the private sector has even less access to credit after financial liberalization than before.

Large, foreign-owned banks come to play a greater role in the domestic financial system following the removal of restrictions on their presence. Large, foreign-owned banks that generally enter developing countries after liberalization are not responsive to the needs of small- and medium-sized enterprises (SMEs) [see Weller, 2001b]. Interestingly, a study of large banks in the USA finds that they are less willing to lend to small firms than are smaller banks [Berger et al 2001]. This finding should give policymakers in developing countries an additional reason to be cautious when abandoning restrictions on cross-border and domestic bank mergers as part of liberalization programs as this can aggravate the serious financing constraints already faced by SMEs.

There is a large body of empirical evidence demonstrating that domestic financial liberalization has unambiguously failed to deliver most of the rewards claimed by its proponents [e.g., Arestis and Demetriades, 1997; Williamson and Mahar, 1998; Zhu, Ash and Pollin, 2004, 1998; Ang and McKibbin, 2005]. Domestic savings have not responded positively to liberalization. Financial liberalization has not promoted long-term investment in the types of projects or sectors that are central to development and to the amelioration of social ills, such as unemployment, poverty, and inequality. Financial liberalization has created the climate, opportunity and incentives for investment in speculative activities and a focus on short-term financial as opposed to long-term developmental returns. Granted, the creation of a speculative bubble may temporarily
result in an increase in investment and overall economic activity. But an unsustainable and financially fragile environment or what Grabel [1995] terms “speculation-led development” is hardly in the long-term interest of developing countries. Such an environment certainly does not improve the situation of the poor—indeed it worsens their conditions of life, as we will see.

One channel by which the speculation-led development induced by financial liberalization worsens the situation of the poor is through its effect on financial fragility, and ultimately on the prevalence of currency, banking and overall financial crises. Many empirical studies find that financial liberalization often leads to currency and banking crises [see Grabel, 2003b, and references therein]. Chile, Argentina and Uruguay experienced financial collapses following their experiments with liberalization in the mid-1970s. Since then we have seen financial crises on the heels of liberalization in a great many developing countries, such as Russia, Nigeria, Jamaica, Korea, Thailand, Indonesia, Mexico, and Turkey. Contrary to the orthodox view, the financial innovation and associated increase in liquidity that follows liberalization imparts greater risk and instability to the financial system and the economy. The promotion of capital markets -- especially when they are internationally integrated and liberalized--exacerbates the problem of financial fragility that so frequently culminates in crises, the burdens of which always fall disproportionately on the economically vulnerable and politically weak groups within society.

Financial liberalization also can worsen the situation of the poor by increasing income and wealth inequality and by aggravating existing disparities in political and economic power. This is because only a very small proportion of the population is situated to exploit the opportunities for speculative gain available in a liberalized financial environment. Speculation-led development often creates a small class of financiers who maintain greater ties to financial markets abroad than to those in their own country, and it is also associated with a shift in political and economic power from non-financial to financial actors [Grabel, 2002; Harvey, 2005; Panitch and Gidgin, 2004:]. In such an environment, the financial community becomes the anointed arbiter of the “national interest” [Grabel, 2003b]. This means that macroeconomic policies that advance the interests of the financial community (such as those that promote low inflation, high interest rates, fiscal restraint, etc) are justified on the basis that they serve the broader public interest when this is rarely the case. Indeed, restrictive macroeconomic policies have a disproportionately negative effect on the poor and women [Braunstein and Heintz, 2006].

Orthodox economists often herald the disciplining effects of capital markets, arguing that the threat of investor exit and corporate takeovers creates pressure to improve corporate governance. We know that the exit and takeover mechanisms are well developed in the markets of the USA and UK. But there is simply no evidence to support the case that these mechanisms have, on balance, been beneficial. Indeed, numerous studies find that the threat of investor exit shortens the time horizon of managers, and takeovers have increased concentration and induced job losses. The case that developing country firms
and consumers benefit from enhancing possibilities for exit and takeover is therefore without merit.

It should also be noted that there is no demonstrated empirical or historical relationship between a market-based allocation of capital and satisfaction of growth and social objectives. This is not surprising since the allocation of capital in market-based systems relies on private financial returns (i.e., profits) as the singular yardstick of investment success. The private financial return on an investment can be quite different from its developmental (or what we might term its social) return. For example, the developmental return on an investment in the provision of clean water is likely to exceed its private return. The divergence between private and developmental returns means that alternatives to the market-based allocation of capital are necessary to promote investment that is socially necessary, but not necessarily privately profitable.

Moreover, despite the claims of orthodox economists, a market-based allocation of capital is not a magic cure for inefficiency, waste, and corruption. Liberalization frequently changes the form, but not the level, of corruption or inefficiency. The situation of Russia after financial liberalization exemplifies this point, but the country is by no means exceptional in this regard [on Russia, see Kottz, 1997]. For instance, research on Nigeria, South Korea, and South America describes quite persuasively the corruption that so often flourishes following financial liberalization [Burkett and Dutt, 1991; Chang, 1998; Crotty and Lee, 2004; Lewis and Stein, 1997]. Thus, financial liberalization does not resolve the problems of corruption and the lack of transparency that frequently operate to the detriment of the poor.

As with domestic financial liberalization, the case for liberalizing international capital flows is not supported by evidence. Numerous recent cross-country and historical studies demonstrate conclusively that there is no reliable empirical relationship between the liberalization of capital flows and performance in terms of inflation, economic growth or investment in developing countries [e.g., Eichengreen, 2001; Rodrik, 1998; Lee and Jayadev, 2006]. Moreover, there is now a large body of unambiguous empirical evidence that shows that the liberalization of international private capital flows is strongly associated with banking, currency and financial crises [Demirgüç-Kunt and Detragiache 1998; Weller 2001a].

Studies also show that liberalization is associated with increases in poverty and inequality, though the authors of these studies take care to point out that it is difficult to isolate the negative effects of financial liberalization from those associated with broader programs of economic liberalization (involving, for instance, the simultaneous adoption of trade and labor market liberalization). With this caveat in mind, it is worth noting that Weller and Hersh [2004] find that capital and current account liberalization hurt the poor in developing countries in the short run. The poor are harmed by financial liberalization through a chain of related effects that have been established in several studies. Increased short-term international financial flows (especially portfolio flows) are often associated with a greater chance of financial crisis [Kaminsky and Reinhart, 1999; Weller, 2001a], especially in more liberalized environments [Demirgüç-Kunt and Detragiache, 1999]; financial crises have disproportionately negative consequences for a country’s poor.
[Baldacci et al., 2002; Frankenberg, et al., 2002]; low-income earners are more likely to be affected by declining demand as unemployment rises following a financial crisis [Eichengreen, et al, 1996]; and the poor are the first to lose under the fiscal contractions and the last to gain when crises subside and fiscal spending expands [Ravallion, 2002]. Cornia [2003] also finds a good deal of suggestive evidence that financial liberalization has a negative impact on the poor (and he also brings together evidence from a variety of studies). Of the six components of what he terms the “liberal package,” Cornia finds that capital account liberalization appears to have the strongest impact on widening within-country inequality. He finds that the next most important negative effects on the poor derive from domestic financial liberalization, followed by labor market deregulation and tax reform. Finally, Weisbrot et al. [2001] concludes that there is a strong prima facie case that some structural and policy changes implemented during the last two decades, such as financial liberalization, are at least partly responsible for worsening growth and health and other social indicators.

Liberalized financial markets are at least as apt as governments to allocate international capital flows in an inefficient, wasteful or developmentally unproductive manner. In so many developing countries, increased access to international flows following liberalization financed speculation in commercial real estate and the stock market, the creation of excess capacity in certain sectors, and allowed domestic banks and investors to take on positions of excessive leverage, often involving currency and locational mismatches that culminate in crises.

The liberalization of capital flows frequently introduces problems with the exchange rate that spill over to other sectors of the economy. Under a system of market-determined (i.e., floating) exchange rates, large, sudden inflows of capital to a country can put pressure on the domestic currency to appreciate. A large appreciation of the domestic currency is problematic because it can undermine the country’s balance of payments position. The flipside of capital inflows is, of course, the possibility of capital outflows (e.g., dividend payments to foreign investors, interest payments to foreign lenders, and the liquidation of stock portfolios). Sudden, large capital outflows can place pressure on the domestic currency to depreciate. Capital flight often induces a vicious cycle of additional flight and currency depreciation, debt-service difficulties and reductions in stock (or other asset) values. This is because panicked investors tend to sell their assets en masse to avoid the new capital losses brought about by anticipated future depreciations of currency or asset values [Taylor, 1991]. In this manner, capital flight introduces or aggravates existing macroeconomic vulnerabilities and financial instability. These can culminate in a financial crisis, an event that seriously compromises economic performance and living standards (particularly for the poor) and often provides a channel for increased foreign influence over domestic decision-making.

Finally, just by looking at the data, it is obvious that international private capital flows cannot perform the Herculean tasks assumed by orthodox economists. Before turning to the data, let us clarify some terminology. International private capital flows consist of four main types--foreign bank lending, portfolio investment (PI), foreign direct investment (FDI) and remittances. Foreign bank lending refers to the loans extended by
commercial banks or multilateral institutions to domestic public or private sector borrowers. PI refers to the purchase of stocks, bonds, derivatives and other financial instruments issued by the private sector in a country other than one in which the purchaser resides. In the case of bonds, these can be also be issued by the government and purchased by private investors. FDI refers to the purchase of a “controlling interest” (defined as at least 10% of the assets) in a business in a country other than one in which the investor resides. FDI can take two forms: “greenfield” investment which involves the creation of a new facility, e.g., the construction of a factory by a foreign investor; or “brownfield” investment, namely, mergers and acquisitions that involve the purchase of assets of existing domestic firms. The cross-border purchase of real estate is also classified as FDI. Private remittances refer to international resource transfers between individuals. The most common type of remittance occurs when a family member that is working abroad sends funds (i.e., wage remittances) to a family member in the home country.

Data on international private capital flows show that despite the growth of PI and FDI flows to developing countries during the 1990s, their share of global private capital flows is still rather small and remains highly concentrated in a few large countries. With regard to concentration of FDI, Brazil, China, India, Mexico and the Russian Federation received just over 60% of net FDI inflows to all developing countries in 2004, and China accounted for one-third of the net FDI inflows that went to all developing countries. Low-income countries in 2003/2004 received about 11% of the net FDI and the same percentage of the portfolio equity flows that went to all developing countries. China, India and South Africa together accounted for 82% of all portfolio equity flows that went to developing countries in 2004, and China alone accounted for almost 40% of the net PI that went to all developing countries.

Inflows of private remittances are becoming an increasingly important part of the financial landscape in some developing countries and regions. As is the case with PI and FDI, remittance inflows are also highly concentrated in a group of developing countries. In terms of the dollar value of remittances, the five main recipient countries are India, Mexico, China, Pakistan and the Philippines [World Bank, 2005]. In 2003 these five countries received almost 84% of the remittances that went to all developing countries. In 2004 low-income countries received 35% of the remittances that went to all developing countries. This concentration means that the potential of many developing countries to harness remittances in the service of pro-poor growth is rather limited.

There is no reason to expect these trends in the concentration of international private capital flows to reverse in the near future. Thus, it is imperative that advocates of pro-poor financial policy recognize the importance of strategies that both mobilize domestic savings in service of pro-poor growth, and that maximize the potential of the international private capital flows that are received to serve this agenda. We consider such mechanisms in sections 4-6 of this module.

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2 All data in this and the next paragraph from World Bank [2005].
3. Challenges with Current Financial Structures

Financial structures in many developing countries are not fostering development and poverty reduction. The same can be said of the global financial system. In what follows, we highlight six key problems with current financial structures in the developing world.\(^3\)

**Challenge #1: Real Interest Rates and Interest Rate Spreads are high**

Despite financial liberalization, interest rate spreads and real interest rates remain very high in a number of developing countries. Table 1 shows that in 2003, differences between interest rates on deposits and those on lending was extremely high in a number of poor countries, while in many real interest rates remained above 10 percentage points.

<table>
<thead>
<tr>
<th>Country</th>
<th>Deposit Rate 2003</th>
<th>Interest Rate of Interest 2003</th>
<th>Lending Rate of Interest 2003</th>
<th>Real Interest Rate 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>6.9</td>
<td>20.8</td>
<td>15.5</td>
<td></td>
</tr>
<tr>
<td>Bangladesh</td>
<td>7.8</td>
<td>16.0</td>
<td>11.0</td>
<td></td>
</tr>
<tr>
<td>Bolivia</td>
<td>11.4</td>
<td>17.7</td>
<td>11.9</td>
<td></td>
</tr>
<tr>
<td>Cambodia</td>
<td>2.0</td>
<td>18.5</td>
<td>15.9</td>
<td></td>
</tr>
<tr>
<td>Cameroon</td>
<td>5.0</td>
<td>18.0</td>
<td>16.9</td>
<td></td>
</tr>
<tr>
<td>CAR</td>
<td>5.0</td>
<td>18.0</td>
<td>14.9</td>
<td></td>
</tr>
<tr>
<td>Gabon</td>
<td>5.0</td>
<td>18.0</td>
<td>19.4</td>
<td></td>
</tr>
<tr>
<td>Honduras</td>
<td>11.5</td>
<td>20.8</td>
<td>11.2</td>
<td></td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>5.0</td>
<td>19.1</td>
<td>14.8</td>
<td></td>
</tr>
<tr>
<td>Lao PDR</td>
<td>6.6</td>
<td>30.5</td>
<td>11.8</td>
<td></td>
</tr>
<tr>
<td>Mongolia</td>
<td>14.0</td>
<td>26.3</td>
<td>20.6</td>
<td></td>
</tr>
<tr>
<td>Nicaragua</td>
<td>5.6</td>
<td>15.5</td>
<td>9.4</td>
<td></td>
</tr>
<tr>
<td>Tanzania</td>
<td>3.0</td>
<td>14.5</td>
<td>8.3</td>
<td></td>
</tr>
<tr>
<td>Uganda</td>
<td>9.8</td>
<td>18.9</td>
<td>8.0</td>
<td></td>
</tr>
<tr>
<td>Zambia</td>
<td>22.0</td>
<td>40.6</td>
<td>17.1</td>
<td></td>
</tr>
</tbody>
</table>

Source: *World Development Indicators* 2005. Table 5.7

Clearly, with real interest rates and spreads such as these, the financial intermediation process in developing countries cannot contribute greatly to real capital formation, and financial intermediation certainly cannot speak to the needs of the poor or small- and medium-sized businesses.

\(^3\) This section draws on McKinley [2006a].
**Challenge #2: Credit Creation is too low**

In many poor countries, high spreads and real interest rates are associated with relatively low rates of credit creation. Table 2 shows that in low-income countries, including Sub-Saharan Africa, interest rate spreads and the amount of credit available lags behind other regions of the world, where financial conditions are more favorable. Indeed, in Sub-Saharan Africa the domestic credit creation to the private sector on most of the continent is lower than the 63.7 percent of GDP because the extremely high rate in South Africa substantially raises the average for the rest of Sub-Saharan Africa. (See Tables 2 and 3).

<table>
<thead>
<tr>
<th>Low-Income Countries</th>
<th>Sub-Saharan Africa</th>
<th>South Africa</th>
<th>South Asia</th>
<th>East Asia and the Pacific</th>
<th>Middle-Income Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic Credit to the Private Sector (% of GDP)</td>
<td>27.0</td>
<td>63.7</td>
<td>158.2</td>
<td>31.0</td>
<td>123.6</td>
</tr>
<tr>
<td>Interest Rate Spread(^a) (percentage points)</td>
<td>12.4</td>
<td>12.4</td>
<td>5.2</td>
<td>7.3</td>
<td>5.2</td>
</tr>
</tbody>
</table>

Source: McKinley, 2005. World Bank, World Development Indicators 2005, Table 5.5
Note: ‘a’ lending minus deposit rate.

Table 3 provides country by country and country group information concerning domestic credit

<table>
<thead>
<tr>
<th>Country</th>
<th>Domestic Credit to the Private Sector 1990</th>
<th>Domestic Credit to the Sector 2003</th>
<th>Domestic Credit Provided by the Banking Sector 1990</th>
<th>Domestic Credit Provided by the Banking Sector 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>40.4</td>
<td>6.0</td>
<td>58.7</td>
<td>5.5</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>16.7</td>
<td>28.8</td>
<td>23.9</td>
<td>38.4</td>
</tr>
<tr>
<td>Bolivia</td>
<td>24.0</td>
<td>49.0</td>
<td>30.7</td>
<td>60.0</td>
</tr>
<tr>
<td>Cambodia</td>
<td>---</td>
<td>7.9</td>
<td>---</td>
<td>7.2</td>
</tr>
<tr>
<td>Cameroon</td>
<td>26.7</td>
<td>10.2</td>
<td>31.2</td>
<td>16.0</td>
</tr>
<tr>
<td>CAR</td>
<td>7.2</td>
<td>5.9</td>
<td>12.9</td>
<td>14.7</td>
</tr>
<tr>
<td>Gabon</td>
<td>13.0</td>
<td>10.8</td>
<td>20.0</td>
<td>17.5</td>
</tr>
<tr>
<td>Honduras</td>
<td>31.1</td>
<td>40.6</td>
<td>40.9</td>
<td>37.7</td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>---</td>
<td>4.8</td>
<td>---</td>
<td>11.4</td>
</tr>
<tr>
<td>Lao PDR</td>
<td>1.0</td>
<td>6.5</td>
<td>5.1</td>
<td>10.1</td>
</tr>
<tr>
<td>Mongolia</td>
<td>19.0</td>
<td>30.3</td>
<td>72.4</td>
<td>38.0</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>112.6</td>
<td>26.4</td>
<td>206.6</td>
<td>96.5</td>
</tr>
<tr>
<td>Tanzania</td>
<td>13.9</td>
<td>7.6</td>
<td>34.6</td>
<td>8.4</td>
</tr>
</tbody>
</table>
to the private sector overall, and domestic credit from the banking sector to the overall economy, including the government. For a large number of countries and for low income countries as a whole, there has been very little increase, and, in many cases, a decline in the amount of credit to the private sector and to the economy as a whole from banks, the dominant financial institution for these countries. By contrast, in the middle and high income countries, there has been a substantial increase.

In most of these countries, credit creation relative to GDP fell between 1990 and 2003, while for all low income countries, it rose somewhat, but is still at low levels relative to other regions of the world.

**Challenge #3: Global Savings are badly misallocated**

Are savings rates too low? In some cases yes, but a bigger issue is that savings are badly mis-allocated globally. As table 4 shows, in recent years a handful of rich countries, most notably the United States, has been running savings short-falls relative to investment, while many other regions of the world have been saving more than they have been investing. As a result, poorer countries have become net lenders of resources to the United States, or have borrowed from the rest of the world much less than they had in earlier periods. In short, the global allocation of resources is going from most of the world, including many relatively poor or middle income countries, and to the United States. In recent years, then, the United States has been utilizing a huge share of the world's savings. As Aizenman, et. al. (2004) confirm, most developing countries self-finance their own investment, making little productive use of the global capital market. Yet, as we have just seen, for many poor countries, the domestic financial markets are not serving them well either.

**Table 4**

**Trends in Savings, Investment and Net Lending**

**Per Cent of GDP**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>24.2</td>
<td>22.9</td>
<td>--</td>
<td>24.0</td>
<td>22.9</td>
<td>--</td>
<td>24.6</td>
<td>24.9</td>
<td>--</td>
</tr>
<tr>
<td>Industrial Countries</td>
<td>22.7</td>
<td>22.1</td>
<td>-0.6</td>
<td>21.6</td>
<td>21.1</td>
<td>-0.5</td>
<td>20.7</td>
<td>19.4</td>
<td>-1.8</td>
</tr>
<tr>
<td>US</td>
<td>20.2</td>
<td>17.5</td>
<td>-2.8</td>
<td>18.5</td>
<td>16.1</td>
<td>-2.4</td>
<td>19.6</td>
<td>13.6</td>
<td>-6.0</td>
</tr>
<tr>
<td>Euro Area</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>0.3</td>
<td>20.2</td>
<td>20.9</td>
<td>0.7</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: *World Development Indicators* 2005. Table 5.7; Table 5.5
As Table 4 shows, Africa is still a net borrower of funds and its overall savings rate is lower than that of the rest of the world. This is not terribly surprising given the profound poverty that characterizes so many countries on the continent. So mobilizing more savings in Sub-Saharan Africa, in principle, would be an important goal. However, if that savings fails to translate into domestic investment and instead goes overseas, then raising the savings rate there would do little for growth or the poor. In Africa, especially, the problem of capital flight is an important one [Boyce and Ndikumana, 2001]. Capital management techniques, as we discuss in section 6, can help stem this capital flight.

**Challenge #4: Credit and Capital Flows are Pro-Cyclical**

When capital flows do come into many developing countries, they are often short-term and pro-cyclical, and sometimes associated with "sudden-stops". These can, in turn, lead to financial crises that can have devastating economic impacts, often especially for women and the poor. [Palma, 2000; Ocampo, 2003; Singh and Zammit, 2000]. Estimates place the average cost of a severe financial crisis at 10% of GNP [Rodrik, 2006]. These instability creating lead many countries to accumulate large amounts of foreign exchange reserves which are very costly to hold, and could be better spent on domestic investment [Mckinley, 2006].

**Challenge #5: Absence of Long-Term, Patient Capital**

The short term and unstable flows of international capital represent a more general, severe problem facing many developing countries -- namely, there is a dearth of long-
term, patient capital to support long-term investment [Stallings and Studart, 2006]. Most capital is of a highly short term nature, especially in the poorest countries in Africa, Asia and Latin America. As a result, long-term productive investment is extremely difficult and costly to finance.

**Challenge #6: Insufficient Capital for Small and Medium Enterprises and the Poor**

Finally, there is a lack of capital for small and medium enterprises and the poor in most regions of the world [Stallings and Studart, 2006]. This problem flows from many of the "stylized facts" described earlier: the high real interest rates and interest rate spreads, the mis-allocation of global financial resources, the short-term and pro-cyclical nature of international capital flows, and the absence of long-term, patient capital.

Pro-poor financial policies must solve many of the problems discussed here in order to succeed. To promote pro-poor growth (as we note above in section 1.2), the financial system must achieve the following objectives (see Box 1):

**Box 1: Roles of Financial Sector in Pro-Poor Growth**

- Mobilize savings that can be used for productive investment and employment creation
- Create credit for employment generation and poverty reduction at modest and stable real interest rates
- Allocate credit for employment generation and to help the poor build assets, including in agriculture and to small and medium enterprises and housing
- Provide patient (long-term) credit for productivity enhancing innovation and investment
- Provide financing for public investment to provide for employment generation and productivity enhancement
- Help to allocate risks to those who can most easily and efficiently bear those risks
- Help to stabilize the economy by reducing vulnerability to financial crises, pro-cyclical movements in finance, and by helping to maintain moderate rates of inflation
- Help the poor by providing basic financial and banking services

In sections 4-6 of this module we describe a range of policies that can help meet these challenges and survey some experiences with financial institutions and policies that have been associated with developmental finance, and we will assess their successes and failures. We will see that these policies tended to be the most successful when they satisfied several conditions:

- They had strong monitoring mechanisms in place to increase the likelihood that they could achieve their goals
- They operated in a context of robust aggregate demand so that there was a facilitating environment for economic growth
• They also operated in a domestic and international environment in which there was not a large degree of instability; and
• They were part of a coherent overall developmental plan implemented by the government.

4. Mobilizing and Channeling Savings for Pro-poor Growth: A Consideration of Policy Options

Domestic financial policy in developing countries should be driven by the following objectives: the financial system should operate in the service of sustainable, stable and equitable economic growth, and it should place improvement of the living standards of the poor at the heart of its operation. The chief function of the domestic financial sector in developing countries is to provide finance in adequate quantities and at appropriate prices for the public and private investments and social expenditures that are central to a pro-poor growth agenda. Domestic financial policies that mobilize and channel domestic savings should be evaluated against the extent to which they serve these ends. Any domestic financial reforms that improve the functioning of the financial system along other dimensions (such as enhancing its liquidity, international integration, etc.) should be secondary to the primary goal of promoting pro-poor growth.

In what follows, we will see that there are numerous ways that domestic financial policy can be oriented towards a pro-poor growth agenda. Before turning to specific policies, however, there are three general points to make about all of the policy options that we present here.

First, the appropriate mix of domestic financial policies for any one country depends on its unique national conditions. Most important among these are the character and institutional structure of the national financial architecture; institutional, regulatory and administrative capacities; and historical, political and economic conditions. Simply put: there is no single template for domestic financial policy -- what is a feasible, desirable, appropriate approach to policy in one country may not work in another.

Second, in this module we discuss separately policy options for the domestic financial sector, central banks, and international capital flows. In practice, there is a strong element of complementarity among these three components of the overall financial environment. Indeed, the success of policy initiatives in one particular domain depends critically on the success of enabling or supporting policies in other domains. For instance, we will see in section 5 of this module that a developmental central bank is critical to the success of many of the policies towards the domestic financial sector that we discuss in this section. Similarly, we will see in section 6 of this module that certain policies toward international capital flows (such as those that restrict outflows) buttress efforts to mobilize domestic savings. There is also a complementarity between fiscal policies (see module #1) and efforts to mobilize domestic savings. For instance, fiscal

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4 The discussion in sections 4.2.-4.4 and 4.6 draws heavily on Chang and Grabel [2004: ch. 10], except where noted.
policies that promote domestic savings and enhance the collection of taxes from the wealthy and from large firms (especially the foreign firms that are too often granted tax holidays) necessarily increase the available pool of resources that can be allocated toward activities that serve a pro-poor growth agenda.

Third, monitoring, performance assessment and policy dynamism are critical to the success of and political support for all of the policies that we discuss in sections 4-6 of this module. Evidence from many countries shows that development banks and other specialized banks, programs of direct credit allocation, lending targets, credit guarantees, loan subsidies, tax credits and state subsidies for targeted lending can all be managed and regulated effectively if the government and the banking sector have the ability and commitment to monitor and assess these initiatives consistently. The maintenance of transparent and consistently enforced performance targets is extremely important to ensuring that the policy measures discussed here can achieve their stated goals. The design of assessment measures and the technical ability to carry them out should be an integral part of the process of designing financial policies—these measures should not be an afterthought that is hastily patched together once policymakers become aware of certain problems, such as the misallocation of resources.

Equally important to policy success is a commitment to dynamic, rather than static, approaches to financial policy (see Grabel, 2004; Epstein, Grabel and Jomo KS, 2004; and discussion in section 6 of this module). That is, policymakers should maintain a commitment to strengthening, weakening or even phasing out financial policies when the economic environment changes in such a way that renders old strategies no longer useful or viable or when a policy’s objectives have been achieved.

It is critical to acknowledge that the challenges of effectively monitoring and adjusting policies are neither greater nor lesser than the challenges associated with managing private banks and international capital flows in a volatile, liberalized environment. This is a point often overlooked by orthodox economists when they quickly reject the kinds of policies that we discuss here on the grounds that they do not have a proven track record or that developing countries have insufficient institutional capacity to manage them.

With these three considerations in mind, we now describe a range of strategies toward the domestic financial sector that can be used to mobilize and/or allocate domestic savings in the service of a pro-poor growth agenda.

4.1 Deposit insurance to enhance confidence in the banking system

McKinley [2005] calls attention to the difficulty that banks in developing countries confront in trying to mobilize deposits. There are many reasons for this, and one of the most important of these factors is a lack of a properly funded deposit insurance system. There is every reason to believe that a properly funded and managed system of deposit insurance could help overcome the public’s lack of confidence in the domestic banking system, and thereby contribute to an increase in the deposit base available for bank lending [McKinley, 2005: 24].
4.2 Direct credit allocation and subsidized lending

There are many ways that governments can and have influenced the price and allocation of credit in accordance with their economic and social goals. Interest rate controls and programs of direct credit allocation by the government to key sectors and firms was central to the improvement of living standards and to the attainment of growth and industrialization goals in Japan, most Continental European and East and Southeast Asian countries, and Brazil during in the post-WWII era [see Chang and Grabel; 2004; Stiglitz 1994; Chang, 1994; Wade, 1990]. More recently, China, Taiwan Province of China (POC), and India have all used programs of direct credit allocation successfully (see Epstein, et al., 2004 for details). All of the governments mentioned here have also subsidized lending in accordance with various economic and social goals.

4.3 Lending targets and ceilings and tax incentives

Lending targets or tax credits can promote bank lending in support of a range of identified economic and social goals through a number of means. Government influence over loan allocation can involve the establishment of transparent lending targets that are imposed on private, quasi-private or publicly-controlled banks. Today, such programs are in place in a number of countries. For instance, in India, Nepal, Pakistan and to some extent, the Philippines, banks are required to channel significant proportions of their loan portfolios to agriculture and other sectors identified as disadvantaged.\(^5\) In India, all commercial banks and regional rural banks are required to lend 40% of net bank credit to identified priority sectors. Within this 40% target, at least 18% of net bank credit must go to agricultural borrowers, 10% must be to identified “weaker” sectors (namely, small and marginal farmers, rural artisans and agricultural laborers), and the remaining 12% must be allocated to either the previously mentioned types of borrowers or to small-scale industry. Of the lending to small-scale industry, 40% of it must be allocated to what are termed “tiny” industry.

The tax system can also be used to direct credit towards those projects that fall within a pro-poor growth agenda. Tax incentives can encourage banks to lend to certain types of firms or sectors, or to particular social groups, such as the poor, first-time entrepreneurs, women, and ethnic minorities.

Another strategy that can be employed by governments is the establishment of ceilings on the percentage of bank loan portfolios that can support activities in “non-priority” sectors or activities, such as securities trading, real estate, or off-shore investments. For example, Taiwan POC had such a program in place from 1989 to 1995. The lending ceiling limited the ability of banks to lend to the real estate sector. This ceiling was introduced following the development of a real estate bubble that caused fears of financial instability [for details on Taiwan POC, see Epstein et al. 2004; Chin and Nordhaug, 2002]. Governments can also preclude all banks or certain types of banks from participating in non-priority sectors, such as securities trading.

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\(^5\) Discussion of India, Pakistan and Nepal from Pickbourn [2006: 10].
4.4 Specialized lending institutions and development banks

Specialized lending institutions can be established to serve particular mandates. These might include encouraging entrepreneurship among women, minorities or the poor, supporting the development of SMEs, or promoting the development of new technologies (such as those that promote good environmental outcomes).\(^6\)

Another means of ensuring the provision of finance to particular sectors or firms is through the creation of development banks that have narrow mandates. Development banks can be publicly financed and managed as in Brazil, Korea, Japan, and France, or can be privately financed as in the case of German industrial banks. It is also conceivable that these banks could be organized as a public-private hybrid, and could raise capital on international markets and even from private donors.

Development banks are the institutional counterpart of the industrial policies and public investment programs that have been critical to the success of late developing (or “newly industrializing”) countries, as the experiences of several countries suggest. We now consider the performance of development banks in the “developmental states” of the post-war period. Amsden [2001] describes how many late industrializing countries developed a manufacturing base and industrialized rapidly after WWII (moving, eventually into mid-level and even high-technology production) through the state’s efforts to harness the domestic financial system to mobilize and allocate medium- and long-term finance for industrialization. She shows that policymakers in these developmental states utilized stringent control and monitoring mechanisms to ensure that the investment projects and firms that received finance from development banks were at the heart of the state’s industrialization goals. Where development banks were most successful they were supported by developmental central banks (see section 5 of this module) and firm performance standards. The latter often involved export targets—firms that failed to meet their targets were often denied access to further loans on subsidized terms.

Amsden argues that development banking filled the void left by the absence of other financial institutions in the post-war environment—these banks initially invested in key infrastructure that later generated demand for local labor and inputs that created business groups and local knowledge. Development bankers themselves learned important skills such as project appraisal in the course of their operation (ibid., p. 126). It is important to note that foreign direct investment played a relatively minor role in post-war industrialization and capital formation. Instead, the state, public investment and development banks were critical prime movers of the industrialization process.\(^7\)

Development banks raised capital at home or abroad and then utilized it either to purchase equity in private or public firms or to lend to such firms at below market interest rates. The lending terms of development banks were almost always concessionary (ibid.,

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\(^6\) Note that we discuss microfinance institutions, MFIs, briefly in section 4.10.

\(^7\) Public investment as a share of gross domestic investment in the postwar period ranged from a high of 58% in Mexico to a low of 25% in Brazil (ibid., p. 127).
Effective real interest rates were often low, even negative. The public finance of development banks in many developmental states was often "off-budget" and related to non-tax revenues. It derived from foreign sources, deposits in government-owned banks, postal savings accounts, and pension funds. In East Asia especially, these often occurred outside the general budget and parliamentary process, thereby strengthening the hand of professional bureaucrats, as in postwar France and Japan. Governments in developmental states also controlled non-tax related sources of funding, such as foreign borrowing (through loan guarantees), ownership of financial institutions and the disposal of private savings (for example, through post-office savings banks). According to Amsden, the major weakness of development banks was not that they spent on the wrong industries, but that, in some cases, they spent too much overall. (Also see Stallings and Studart, 2006).

Finally, we note that states played central roles in long-term credit allocation in the post-war era, even in those parts of the world where development banks were of relatively minor importance (e.g., Malaysia, Thailand, Taiwan and Turkey) [Amsden, 2001]. In these cases, the entire banking sector in these countries was mobilized to direct long-term credit to targeted industries, thereby "acting as a surrogate development bank". (ibid., p. 129).

Creating mechanisms to finance public investment programs can be accomplished through fiscal policy reforms (see module #1). But reform of the public debt market can also play a role in this connection, as Epstein and Heintz’s [2006] work on Ghana suggests. In the case of Ghana, they suggest that the government develop longer-term public debt instruments as a way of lowering interest costs (because these are high on short-term instruments) and as means of raising funds to finance public investment. This proposal has obvious relevance outside of the Ghanaian context.

4.5 Credit guarantee schemes to reduce risk premia on medium- and long-term investments

Banks in developing countries are often unwilling to extend credit to medium and long-term investments because of the perceived risks and availability of substitute assets, such as Treasury bills, that have high returns and are less risky. One way of reducing the risk associated with these investments (and thereby encourage lending over the medium- and long-term) is to have the government guarantee a portion of the loan to support approved projects. In a UNDP-sponsored study of Ghana, Epstein and Heintz [2006] propose public underwriting of loans to lower risk premia on investments that support the objectives of employment creation and poverty reduction. Their proposal has relevance beyond this national environment, and we therefore reproduce it here.

In a credit guarantee program the interest charged on guaranteed loans would be lower than the prevailing market rate. The appropriate level for the concessional interest rate would be a weighted average of the market rate of interest for the type of loan extended and the risk-free rate of return on government securities. At this rate of interest, the program would not place any economic burden on the banks that participated in the
guarantee scheme. However, it does suggest that the lowest possible interest rate would be the prevailing rate on government securities (for a 100% secured loan). Therefore, such a credit guarantee program can only lower the cost of borrowing so far. The program would be more effective if paired with other strategies to reduce the average costs of borrowing throughout the economy (on the latter issue, see below).

In a credit guarantee program, borrowers would be required to supply some form of collateral, even if a large portion of the loan were guaranteed. This is an important mechanism for ensuring that loan guarantees do not create perverse incentives. The collateral requirements would be less stringent than for other types of loans. Coupled with monitoring and performance targets, the collateral requirement could reduce the perverse incentives (and potential drain on public resources if the loan were to become non-performing) for borrowers associated with loan guarantees.

**How can borrowing costs be lowered?**

A reduction in domestic interest rates is an important part of a pro-poor growth agenda, particularly because lower interest rates can support some of the programs considered here, such as credit guarantee schemes. Certainly incomes and competition policies might be necessary were reductions in the average interest rate to raise inflation rates beyond a moderate level [Pollin et al., 2006; McKinley, 2005].

Average borrowing costs could be reduced through a number of means. We know that it would be far easier for central banks to lower their prime lending rates were programs of inflation targeting to be abandoned (see module #2 and section #5 of this module) [Pollin et al., 2006; McKinley, 2005]. The introduction or strengthening of competition policies could also address banking sector concentration, and thereby also create the possibility that average interest rates in the economy could be reduced [Epstein and Heintz, 2006; McKinley, 2005]. Enhancing the competitiveness of the process by which government debt is sold (e.g., through government auctions) could also promote reductions in average interest rates because governments would not be able to influence auction outcomes.

Interest rates on desired types of assets can be lowered through a number of means considered in this section of the module. Credit guarantees of the sort described here, asset based reserve requirements (see below, section 4.6) and direct subsidies or concessionary loan rates for especially desirable projects (see above, section 4.2) are all ways that interest rates on some types of projects can be reduced. Note that direct subsidies or concessionary loan rates can be an expensive undertaking, but there may be particular cases, such as for projects with especially large employment multipliers, where such measure maybe worthwhile [McKinley, 2005: p. 23; Pollin et al., 2006].

**4.6 Variable asset-based reserve requirements**

Another means to ensure that the domestic financial system serves the objectives discussed above is through a system of variable asset-based reserve requirements for financial firms. A system of variable asset-based reserve requirements has three chief components: all financial firms in the economy are required to hold differential reserves
against different types of assets in their portfolio, such as stocks, bonds, mortgage, consumer, or small business loans; financial regulators establish and manipulate the required reserve ratio against each type of asset based on the government’s objectives vis-à-vis encouraging certain types of investments (for example, in employment-intensive sectors) and their evaluation of a number of factors, such as the risk associated with that asset and market conditions; and required reserves are held in non-interest bearing deposit accounts at the central bank.

Variable asset-based reserves provide regulators with a means to encourage financial institutions to hold certain types of assets by reducing the ratio of required reserves that must be held against them, and thereby lowering the cost of holding certain assets (and vice versa). Variable asset-based reserves provide regulators with both a means to target sectoral imbalances involving over-investment in some sectors and under-investment in others, and a means to use the financial system in the service of economic and social goals.

A system of variable asset-based reserves can also reduce the risk of financial crisis through two channels. Regulators can use the asset-based reserve requirements to deflate bubbles in particular asset markets as they emerge and before they culminate in financial crisis. The system also functions as an automatic stabilizer because it requires financial institutions to deposit additional reserve holdings whenever asset values rise or whenever new types of assets are created.

4.7 Employment-oriented financial policies: Description of a plan developed for South Africa

As a concrete example of some of these policies, we briefly describe a set of financial market interventions that have been developed by Pollin, et. al. [2006]. They propose a set of employment-oriented financial policies that could contribute to the South African government's goal of reducing unemployment by half in ten years. This plan puts forward a set of credit allocation policies designed to target employment-generating projects. The proposal has clear relevance outside of the South African context. For this reason, we describe it in some detail below.

The plan outlines three main policy tools to channel credit to targeted industries at concessionary rates with the goal of generating employment. A first policy tool is a major expansion in the lending activity and developmental focus of the country's currently existing development banks. The Industrial Development Corporation is South Africa's largest development bank. Its 2005 Annual Report reported that through its lending activity over 2004-05 it anticipated creating 16,700 jobs. But this is far too modest a contribution for such an important institution, given that the official statistic of 4.3 million unemployed people in 2005 is 257 times larger than this figure of 16,700. The capitalization of these banks therefore needs to increase and they should be allowed to assume a higher level of risk on behalf of an employment-targeted growth agenda.
A second policy tool for channeling credit is the establishment of asset reserve requirements for private banks and other financial institutions (see above section 4.6). For example, the plan stipulates that banks should hold 25 percent of their loan portfolio in designated employment-generating activities. If the subsidized activities did not account for at least 25 percent of the banks' total loan portfolio, the banks would then need to cover this gap by holding cash. Features of this proposal are comparable to the system of 'prescribed assets' that operated in South Africa from 1956 to 1989. However, the Pollin et al. [2006] plan proposes more flexible measures (for example, it allows banks that hold more than 25 percent of their loans in subsidized activities to sell permits to institutions whose targeted industries account for below the 25 percent minimum of subsidized loans).

A third tool for channeling credit is a major expansion of the government's system of loan guarantees. The South African government currently has a loan guarantee program but it is much too small. For the Government's current loan guarantee program, the accruals on its contingent liabilities—i.e., the amounts that the Government actually pays when loans default—has been a trivial cost, amounting, on average, to 1/100 of one percent or less over the recent past. The plan described here proposes instead the following program—the Government underwrites about R40 billion per year in loans, i.e., a figure approximately equal to 25 percent of fixed capital formation as of 2004. The plan assumes a default rate on these loans of 15 percent and loan guarantees that cover 75 percent of the principal on defaulted debts. Under this scenario, it follows that the accruals to the Government would amount to R4.5 billion/year (i.e., R40 billion x .15 x .75). This is a crucial result. It shows that the Government has the capacity to underwrite a major loan guarantee program, equivalent to roughly 25 percent of productive investment in the economy, with a financial commitment of no more than 1-2 percent of its fiscal budget.

These three parts of the credit allocation plan amount to having the financial sector subsidize credit for certain borrowers. Three key issues in this connection: who should receive the subsidized credit; what institutions should allocate the credit; and what monitoring should be put in place to insure that the funds are well spent and achieve their desired goals, namely, facilitating pro-poor growth?

Who should receive subsidized credit? The fundamental purpose of the expanded credit allocation policies is to facilitate a program of rapid employment growth. Subsidized credit should be directed toward viable businesses that will expand employment.

The plan proposes that businesses, including co-operatives and non-profit organizations, become eligible for credit based on two sets of criteria. The first is "social priority lending" for small scale activities. Three areas that fall under this heading are: land reform and rural development: these would help generate and build assets for the rural poor; promotion of SMEs: this is a basic problem for many developing countries and should be part of any pro-poor financial policy (Stallings and Studart, 2006); and promotion of collectives and other alternative ownership forms; for the poor, new and
alternative ownership forms can be crucial to individual efforts to leave poverty behind by generating asset ownership and employment.

The second priority is that any firm that does not fall within the "social priority" criterion will be eligible for concessionary loans if it can demonstrate that its project will produce large positive employment effects. So to apply for a loan under this program, firms will have to provide an Employment Impact Statement demonstrating the overall number of jobs that be created by their investment. The employment impact statement should include both the direct and indirect job effects of the project financed by the loan.

Who will provide the loans? According to this plan both public and private financial institutions would provide these loans. There currently are a number of development banks and public and quasi-public financial institutions in South Africa. One of the largest is the Industrial Development Corporation. The Industrial Development Corporation has committed itself to expanding its developmental role in general, including its role in job creation. (Mondi, 2006). The plan would involve expanding the role of the Development Banks such as the Industrial Development Corporation in employment creation, as well as mobilizing the private financial system through loan guarantees and asset reserve requirements.

The plan would also encourage small-scale banking, a so-called second tier set of institutions, to enter the market, perhaps encouraged helped by the Reserve Bank of South Africa (see section 5 of this module). Development banks could encourage this second tier banking system by investing in the creation and expansion of such banks.

The program of loan guarantees would underwrite an expansion of R40 billion, would aim for a default rate of 15%, and the government would guarantee 75% of principal. The cost would be about R4.5 billion/year which comes to about 1.2 % of government spending. This is substantial, but the goal would be to generate thousands of jobs which would expand both the economy and government revenue.

An advantage of this plan is that it would be profitable to private lenders as well as expand credit and employment. But to make sure it works, careful monitoring systems must be set up. The plan proposes that these include a series of employment targets, escrow accounts, reward for whistle blowers who report corruption, and penalties for those who do not meet the targets (readers are encouraged to see Pollin et al. [2006] for details on measures to reduce corruption, fraud and inefficiency as these may be relevant in some contexts).

For those receiving priority lending, they should put part of the loan into escrow accounts the balance of which would be returned when the loan is repaid. The size of the escrow required be inversely related to the size of the subsidy the government wants to give to the borrower. In addition to setting the size of the escrow account, the lender would engage in normal monitoring of the loan. For large scale employment loans (that is for firms that produce Employment Impact Statements), they will be monitored to assure that they fulfill their employment creation promises.
4.8 Improvement of business services and information resources to facilitate lending to SMEs

The lack of skills, technical support, and adequate information limits the willingness of banks to lend to SMEs. Therefore, there is a need to develop capacity for technical assistance, particularly in terms of managing the risks faced by SMEs. For example, legislation could be developed that requires all banks to have a highly functioning desk to deal with SME applications. Specific parameters would be set to evaluate whether banks comply with the regulations. Similarly, government could spearhead policies that support the establishment of credit bureaus that collect and maintain information on potential borrowers. These credit bureaus could be designed to deal specifically with the information problems associated with small-scale credit applications. The credit bureaus could be charged with facilitating financial services between lenders and potential borrowers.

4.9 Forge linkages between informal and formal financial institutions to promote greater access to credit by the underserved

In some countries, informal financial institutions presently fill important needs, namely they provide credit (though often at high cost) to rural communities and to small businesses. The informal financial sector may have an advantage over the formal financial sector in making small loans. However, the lending capacity of the informal sector is clearly limited because its deposit base is necessarily small [Selvavinayagam, 1995]. Policymakers in developing countries have two options when it comes to the informal financial sector-- they can increase the ability of informal financial institutions to perform their traditional functions, or they can enhance the ability of the state and/or the formal financial sector to mobilize and channel capital to the undeserved rural communities and small businesses. The latter strategy is clearly preferable, but we appreciate that the former may be more feasible in some contexts, especially in the short run. For this pragmatic reason, we describe below some strategies for enhancing the performance of the informal financial sector.

By way of background, we should acknowledge that informal financial institutions have diverse organizational structures, and that they interact with formal institutions in a variety of ways. In some cases, informal financial institutions rather closely resemble formal institutions in regards to their scale of operation and average loan size. Interestingly, large-scale informal financial institutions lent substantial sums to medium-sized enterprises in Taiwan POC [Tang, 1995]. These informal financial institutions have been encouraged by the government [Biggs, 1991; Pickbourn, 2006].

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8 Proposal and text from Epstein and Heintz [2006].
9 We are grateful to Lynda Pickbourn for critical research support on mechanisms to forge linkages between formal and informal financial institutions and on Gallardo's [2001] work on microfinance institutions.
In some contexts, informal financial institutions may compete with or substitute for the services provided by formal financial institutions. In other cases, complementarities between informal and formal financial institutions exist. For example, formal financial institutions may lend informally mobilized deposits or informal lenders might act as intermediaries for formal institutions [Aryeetey 2003]. In still other cases, there is little – if any – interaction between formal and informal financial institutions due to the fragmented nature of financial markets in some developing countries [Aryeetey, 1998; Selvavinayagam, 1995].

Policymakers that choose to enhance the performance of the informal financial sector would do well to develop complementary linkages between informal and formal institutions. For instance, relationships could be built between formal banks and rotating savings and credit associations and accumulating savings and credit associations to facilitate group savings and lending for informal and small enterprise development [Amoako-Tuffour, 2002; Aryeetey, 1998]. Aryeetey [1998] suggests that formal banks can encourage informal institutions to place their deposits with them by offering a preferential deposit interest rate and by waiving fees on their demand deposits. In addition, he suggests that an agency-type relationship could be developed among well-established semi-formal (e.g., NGOs, microfinance institutions), informal and formal lenders. In this scenario, formal banks would channel some of their funds to semi-formal and informal lenders for lending to small borrowers. Aryeetey rightly suggests that only recognizable, well-established informal lenders be involved with such a program, namely lending associations, cooperatives and unions. Other mechanisms for forging linkages between formal and informal financial institutions suggested by Aryeetey involve creating tax incentives to compensate formal banks for the costs and risks of developing small borrower portfolios (i.e., offering tax relief to formal banks that allocate some credit through semi-formal and informal agents), and modifying some restrictions on the types of assets that formal financial institutions may hold to encourage them to invest in semi-formal institutions.

Note that developing these new institutional relationships between formal and informal financial institutions will require a broader regulatory structure for suppliers of credit that specifically incorporates a role for informal credit institutions in those countries where informal institutions are currently playing important roles. At this point, the lack of prudential regulation of informal financial institutions may hinder the willingness of formal institutions to increase their ties with informal institutions. It would therefore be important for policymakers to develop an appropriate regulatory framework for informal financial institutions, particularly in those cases where they have chosen to increase the linkages between formal and informal institutions.

There is much research to be done on the issue of regulating informal institutions. Preliminary work along these lines appears in Lapenu [2002] and especially Daley-Harris [2002: ch. 6]. The latter argues that it is important to establish industry norms and standard for unregulated microfinance institutions (MFIs), and to develop appropriate means to reinforce these performance standards. Daley-Harris [2002] proposes specific

\[10\] Proposal and text from Epstein and Heintz [2006]
performance indicators and norms that can be used by regulators in monitoring the
microfinance portfolios and organizational capabilities of regulated banks and MFIs.
Aryeetey [1998] suggests a three-tiered approach to regulation and supervision of the
informal sector: formal banks lend to credible, semi-formal agents who then link up with
informal lenders; rural/small borrowers receive loans directly from informal agents; and
semi-formal institutions can then be the agencies responsible for regulation of smaller,
informal units.

4.10 Enhance the ability of Micro Finance Institutions (MFIs) to serve borrowers

Much has been written over the last decade about the remarkable growth of diverse types
of MFIs across all regions of the developing world [e.g., Versluysen, 1999; Daley-Harris,
2005, 2002; Zeller and Meyer, 2002]. Though the structure and operating practices of
these institutions remains quite heterogeneous, they generally share a commitment to
serving those social groups and small-scale businesses that are not served by the formal
financial sector. The lending of MFIs can therefore promote some degree of employment
creation and poverty alleviation by providing opportunities for business activity by those
groups, such as women, and to those areas of the country (especially rural areas) that
normally face severe credit constraints.

However, it should be obvious that MFIs are not the development panacea that many
enthusiasts suggest. Indeed, Rahman [1999], Grosh and Somolekae [1996], and
Christensen [1993] raise issues that complicate the generally sanguine view of MFIs, and
essays in Zeller and Meyer [2002] also offer a more nuanced empirical view of MFIs
than one generally finds in the literature. It is clear that MFIs cannot play a central role
in promoting pro-poor growth, nor are they appropriate institutional form to resolve
problems of savings mobilization or allocation on the macroeconomic level.

Nevertheless, MFIs are a part of the financial landscape in many developing countries,
and they are supported by many external donors. Thus, it is reasonable here to consider
how the potential of MFIs to contribute to savings allocation and mobilization can be
enhanced by the supportive actions of developmental central banks and/or by external
actors. In what follows, we briefly survey the most successful efforts to provide support
to MFIs.

Central banks specifically support MFIs through credit guarantees and insurance,
participation in the capital and management of MFIs, establishment of priority sector
lending requirements, differential interest rates, preferential rediscount rates and facilities
that target credit/deposit ratios for rural bank branches.\textsuperscript{11} External support has been
crucial to the success of almost all MFIs. Central banks have generally not provided
direct financial support to MFIs that are not licensed financial institutions. But there are
a number of important exceptions. In Bangladesh, for example, the central bank provided
support to the Grameen Bank from as early as 1979, before it was established as a
specialized development bank in 1983. The central bank also supported the bank with
lines of credit.

\textsuperscript{11} The description in this and the next paragraph is drawn from Pickbourn [2006].
Central banks may also operate as “second-tier” institutions that channel funds to individual MFIs. In Nepal, for example, the central bank administers the Rural Self-Reliance Fund, which provided wholesale funds to MFIs for lending to final borrowers. In India, the National Bank for Agriculture and Rural Development was established by the central bank as an apex body for rural credit: it provides a small amount of revolving fund assistance to nonbank MFIs, with funding obtained from the Swiss Agency for Development and Cooperation. In Indonesia, the central bank disburses funds to the provincial government commercial banks and rural banks for lending to small financial institutions and micro-entrepreneurs under a micro-credit project that was initiated with support from the Asian Development Bank. These banks have been highly successful in developing appropriate products and processes for reaching micro-entrepreneurs, although interest rates are rather high around 2-4 percent per month). Like the Grameen Bank, they have enjoyed repayment rates of over 95%.

The issue of appropriate regulation for MFIs cannot be ignored, and there is much research that needs to be done in this area. Based on experiences in Ghana and the Philippines, Gallardo [2001] describes a tiered regulatory structure for MFIs and has identified threshold levels of intermediation that trigger the need for external regulation of their activities. External regulation is not called for where MFIs (and informal lenders) do not access funds beyond members’ savings. A higher standard of regulation is called for when MFIs access funds from external sources. In such cases, the standard registration procedures that apply to formal financial institutions (involving, for instance, filing documents regarding establishment and governance structure of the institution) should apply to all MFIs. An even higher level of regulation applies to institutions engaged in financial intermediation that does not include retail deposit-taking activities. These institutions should be monitored through standard periodic reports. Even more stringent regulation would apply to all limited-license banks and non-bank MFIs that are permitted to take deposits from the general public limited to a multiple of the institution’s total qualifying capital. Such institutions may need to comply with higher capital adequacy guidelines and restrictions on their services and operations. The highest level of regulation applies to licensed banks that are permitted to mobilize retail deposits from the general public. These institutions are subject to full offsite and onsite supervision, licensing requirements and full prudential supervision by the regulatory authorities.

5. Central Banks as Agents of Pro-poor Growth: A Consideration of Policy Options

As mentioned in section 4.10 above, central banks can play a role in supporting developmental lending by MFIs and other institutions serving social needs. But, in the last several decades, this "developmental" financial role for central banks has NOT been the norm. In fact, during the last decade, central banks in developing countries have increasingly adopted approaches to monetary policy that focus on lowering the rate of inflation, with little regard to their impact on "real factors" such as poverty, employment, investment or economic growth. Among these approaches, "inflation targeting" is the most prominent [Saad Filho, 2006]. At the same time, they have eschewed the broad
range of tools of central bank policy so widely used by developed country and developing
country central banks for allocating credit to social priority sectors, and managing the
international flows of capital. Instead, most central banks now focus on a narrow range of
stabilization goals, using a narrow range of instruments, primarily short term interest
rates.

Following this strategy, central banks attempt to hit a target range for inflation while
mostly ignoring the impact of monetary policy on other economic variables. As of 2005,
more than nineteen countries had adopted inflation targeting and more countries are
considering doing so [IMF, 2005]. Even where countries do not implement formal
inflation targeting, many of them - under pressure from the IMF and other organizations -
still orient policy almost exclusively to fighting inflation. In many countries, inflation
targeting has generated significant costs -slow growth, sluggish employment generation
and high real interest rates – while yielding, at most, minor benefit. Among the greatest
disappointments for proponents of inflation targeting has been its apparent inability to
reduce the so-called sacrifice ratio, the unemployment costs of fighting inflation. [Saad
Filho, 2006].

Inflation targeting is also typically accompanied by the absence of credit promotion and
allocation policies by the central bank. In line with standard orthodox approaches, the
central bank has eschewed "developmental central banking" in favor of focusing
exclusively on "stabilization" as a goal of economic policy. This focus on fighting
inflation and stabilization more generally, to the exclusion of other ills is particularly
puzzling in light of the well-known evidence that, assuming inflation is within moderate
levels – 10-15% - there are no negative consequences of inflation on important real
variables. [Bruno and Easterly, 1998; Zhu and Pollin, 2005]12 By contrast, the costs of
large scale unemployment and slow growth are high and well understood. South Africa,
for example, where the unemployment rate is above 40%, seems singularly ill suited for
such a policy, yet the South African Reserve Bank is an enthusiastic supporter of
inflation targeting.

Hence, alternatives to this destructive monetary policy must be developed and promoted.
Indeed, a central component of any macroeconomic policy framework that attempts to
tackle the ills of poverty, high unemployment and slow economic growth in developing
countries, must develop a feasible and efficient framework for conducting monetary
policy that is oriented towards these variable goals, while, to be sure, keeping inflation
from escalating beyond a moderate level and keeping other problems in check. Along
these lines, central banks must play a more pro-poor developmental role. This
developmental role has two components, one with respect to monetary policy and the
other with respect to sectoral and credit allocation policies:

12 A key determinant of the impact of inflation on economic growth and distribution, and on the cost of
reducing inflation is the causes of inflation in any particular episode. If inflation is due to increases in
aggregate demand, than the impact on economic growth and the well-being of the poor is likely to be less
harmful (and even can be positive) than if the cause of inflation increases is "supply-shocks". Hence, an
analysis of the "optimal" level of inflation and the proper monetary policy response must include, among
other factors an identification of the causes of inflation. (Pollin and Zhu, 2006)
Monetary Policy: a real targeting framework for central bank policy. In this approach, central banks choose a real target that is appropriate for that particular country – it will normally be poverty levels, employment growth, investment, or real economic growth – and choose a set of monetary policy instruments to achieve that target. Central to this strategy is the recognition that in order to achieve the chosen target, there will normally be other economic constraints that must be confronted, including, most notably, inflation and balance of payments, or exchange rate constraints [Pollin, 1998]. In this situation, the central bank will normally have to hit multiple targets and constraints. Therefore, taking into account the classic Tinbergen analysis, it will need to implement several tools of monetary policy, including perhaps, some new ones.

Sectoral Policy: with respect to sectoral policies, central banks can support institutions for the allocation of credit by financial institutions and the government for sustainable growth and employment generation and the accumulation of productive assets by the poor. We consider monetary and sectoral policies in sections 5.1 and 5.2, respectively.

As we see below, changes in interest rates and other standard monetary tools are important to lowering the cost of credit and expanding aggregate demand, as well as helping to moderate inflation. Training module #2 discusses in detail this component. But, for central banks to have a truly significant impact on generating employment and reducing poverty, in many cases it will have to play a crucial developmental role interacting with the financial sector. A discussion of this "developmental financial role" of central banks will be a key focus of our discussion here.

First, we provide a brief overview of the overall central bank framework that can be conducive to pro-poor growth.

5.1 Monetary Policy: A Real Targeting Approach

This real targeting framework has a number of important advantages.

1. First and foremost, it places front and center the economic variables that have the most immediate and clearest association with social welfare. The central bank will be forced to identify this target and then reach it, and if it doesn't do so, both explain why it failed and how it will improve in the next period.

2. Given the public pressure to reach this target, the central bank will have significant incentives to invest in research and other activities, to improve its understanding and tools to reach this real target.

3. Given that it will need to reach this target amid other constraints, it will need to develop new tools of monetary policy. For example, if a central bank must hit an employment target subject to an inflation and balance of payments constraint, then – in addition to interest rate policy - it might explore asset allocation strategies to encourage banks to lend more to high employment generating uses, and capital control
techniques to manage balance of payments problems [Pollin, 1998; Epstein, Grabel and Jomo, K.S., 2004].

4. A real targeting approach lends itself naturally to a more democratic, transparent and accountable central bank policy that serves the genuine needs of the majority of countries’ citizens, rather than the minority that typically benefits from the combination of slower growth, low inflation, and high real interest rates.

5. The framework is much more conducive to tailoring monetary policy to the specific needs of different countries. For example, if a country has a particular problem with generating good jobs for women, or more jobs in a particular region of the country, then the real targeting approach can target women’s employment or more employment in a specific region (along with more employment generally) and devise instruments to achieve those objectives.

In short, the real targeting approach to monetary policy is likely to be more relevant, flexible and effective than inflation targeting.

5.1.1 Employment targeting and central bank policy: An example

An alternative targeting approach would target “real” variables that contribute directly to the economic welfare of the majority of the country’s residents. The advantage of a targeting approach is that it requires the central bank to identify its goals, makes transparent whether it is reaching that goal, and therefore potentially increases the accountability of the central bank to the general public. Of course, to make accountability a reality, additional political structures must be in place as well. We turn to this issue briefly at the end of this paper.

What real variable should be targeted? This, obviously, will depend on the particular circumstances of the country involved. For some countries with a very large unemployment or underemployment problem, such as South Africa, employment targeting is a good candidate. In other cases, investment growth or real GDP growth would be more appropriate. Unlike the claims made by proponents of inflation targeting, the real targeting approach recognizes that one size does not necessarily fit all. Still, employment targeting is a good example because creating gainful employment must be a crucial element in pro-poor financial policy.

In this section we develop one example, an employment targeting approach to monetary policy. Other examples, such as investment or real GDP targeting would share many of the components described here.

5.1.2 Employment targeting

With employment targeting, central banks would choose, or be given by the democratic authorities, an employment, employment growth or unemployment rate target. The central bank would be required to devise means (i.e., instruments), for achieving that
target. If it fails to achieve the target during the allotted period, it would be required to explain why the target was not achieved, as well as to develop mechanisms for achieving the employment target in the next period. Targeting implemented in this way, contributes to central bank transparency and accountability, and in that sense, this approach takes an important leaf from the “inflation targeting” book.

As mentioned earlier, the evidence indicates that if inflation gets high enough, it can create significant economic and social costs. Hence, no central bank can entirely ignore inflation. So in the employment targeting approach, central banks must achieve their employment target, subject to an inflation constraint. What the inflation constraint is should depend on the particular circumstances of the country involved. But whatever the level, as long as the constraint is binding or could be binding in a given period, an inflation constraint means that the central bank will essentially have two targets – employment and inflation. And as Jan Tinbergen famously put it, policy makers need as many independent instruments as they have independent targets.

Central banks used to have many tools of monetary policy (of which we will speak more below.) But with the rise of neo-liberalism, including financial liberalisation and the elimination of capital controls in many countries, most central banks have dramatically reduced the number of independent monetary tools they use, often to only one, namely, a short term interest rate. This one tool will not generally be sufficient to reach both an employment target and an inflation constraint. Hence, the central bank will have to develop new tools (or dust off old ones), in order to implement this policy. But the need for learning and innovation by the central bank will be much greater than this for a simple but profound reason: most central banks don’t really know very much about how to generate employment. The reasons for this are many, but the most important one is quite simple: for many years now, most central banks didn’t have to worry about generating employment, because they were pressured only to be concerned about inflation (or the exchange rate). As a result, central banks (and associated economics researchers the world over), have devoted millions of dollars and countless hours on economic analysis and modelling to figure out the relationship between monetary policy and inflation, while spending virtually nothing on discovering the relationship between monetary policy and employment generation. So not only will the central bank have to develop new instruments because they have more targets than instruments, but they will have to develop new instruments because the target is “new” and unfamiliar.

Research economists at the central bank will need to start conducting research on how to use monetary tools to generate more employment; they will consult with business, labour, organisations from the “informal economy”, maybe even NGO’s, (to say nothing of the labour ministries in their own government), to try to develop approaches to generating more employment. This re-orientation in research, and even a change in the culture of the central bank, could be one of the most important and long-lasting results of the re-definition of the central bank target.

As central banks learn more about how to use monetary policy to increase employment, and as they develop new tools to reach this target subject to an inflation constraint, they
might discover that they are re-inventing tools that were part of the standard central bank tool kit in the developing world in the 1950s, 60s and 70s: credit allocation policies; the provision of support to development banks; regulations in support of development lending (see below). For the most part, policies such as these that were largely eliminated in the 90’s -- sometimes for good reason, sometimes not -- will be re-discovered, modernized and improved upon.

5.1.3 Complementary institutions and additional considerations

Because a more expansionary monetary policy might lead to other constraints, a central bank that is oriented toward increasing employment is likely to require complementary policies to be successful. These problems might include excessive inflation and capital flight. In addition, further structural changes will be necessary to make central bank policy truly accountable.

Inflation
The monetarist view that inflation is always and everywhere a monetary phenomenon is false [Saad Filho, 2006]. More generally, excessive inflation is not likely to be a prominent problem resulting from an employment targeting approach, as long as other economic policies of the government, including fiscal policy, are responsible and as long as the economy is not subject to excessive external shocks. However, there could be occasions when excessive inflation rears its ugly head and economic policy must be prepared to deal with it. We already discussed monetary policy tools to limit inflation. As the central bank develops new tools to enhance employment growth, it can, if necessary, use traditional monetary policy tools such as short term interest rates, to reach its inflation constraint. In some cases, when using interest rates to fight inflation without interfering with the employment growth target might not be feasible, the central bank might need to consider other policies, such as temporary incomes policies. The combination of policies required will vary depending on the country and the situation.

Capital flight
Foreign and domestic investors might speculate against the central bank policy, leading to capital flight, or more generally, downward pressure on exchange rates and foreign exchange reserves. Capital management techniques, such as capital controls, might be necessary to insulate the economy from such speculative flows. As Epstein, Grabel and Jomo [2004] show, countries use a variety of such techniques successfully to manage their economies. (See section 6 for a discussion of these policies).

5.1.4 Possible objections

Some will raise objections to the employment targeting approach specifically, or the real targeting approach more generally. The most common objection likely to come from mainstream economists is that monetary policy is incapable of affecting real variables, at least in the “long-run”. To adequately address this objection would require a separate paper, but here we would like to mention only a few key points. There are both
theoretical and empirical issues raised by this objection which need to be addressed. On the theoretical side, the notion that monetary policy cannot affect real variables, is based on an incoherent Walrasian macroeconomic model common to orthodox macroeconomics, a system that assumes away problems of uncertainty and unemployment. In Marxian, Keynesian, Kaleckian, Post-Keynesian and even New-Keynesian approaches, there are strong reasons to believe that monetary policy can have long-run, real affects. As an empirical matter, there is a vast literature. It includes strong evidence that monetary policy has real effects.

Additionally, some will argue that developmentalist central banks could be captured by "special interests" leading to "corruption" and "rent seeking". It is true that any government institution that can allocate resources might be implement corrupt policies; but this is not a unique attribute of state-based policies. Private corporations can also be purveyors of corrupt practices, as the multiple cases of massive fraud in Enron and many other companies has demonstrated. The challenge of dealing with corruption, applying to all institutions, involves creating mechanisms of monitoring, transparency and accountability. Such mechanisms apply every bit as much to private corporations and the market as it does to the state.

5.2 Sectoral Policies Used by Developmental Central Banks

Monetary policy typically has been only one component of central bank policy. Using central banks to promote sectoral and industrial development, and in support of government goals to raise the incomes and wealth of sectors of society have also played an important role in the history of central banking. These policies and institutional roles of central banks often go by the term the "developmental" role of central banks [Epstein, 2006; Asian Development Bank, 2000]. This developmental role has now fallen out of favor in policy circles, but, not only was it very important historically, but continues to be used to good effect in some countries [ADB, 2000; Epstein, 2006; Stallings and Studart, 2006]. This developmental role is a key component of monetary policy used for pro-poor growth. Moreover, since the major mechanism by which central banks have engaged in this policy is through its regulation of and interaction with the financial sector, this topic is central to our discussion of financial policies, even as it falls in the intersection between financial policy and central bank policy.

Historically, the role of central banks as agents of pro-poor development policy varied from country to country. Using country examples from Amsden [2001] one can see that In India and China, for example, central banks played a crucial role as part of the planning apparatus and were key players in the allocation of medium and long-term credit to industrial sectors. In Mexico and Thailand, the role was less important. In Brazil and South Korea, the role of central banks occupy a middle ground between these two groups’ roles. In short, while not all developing country central banks played a developmental role, in many they did so quite successfully.
5.2.1 India and China

Mr. P.C. Bhattacharyya, a former governor of the Reserve Bank of India (1962-1967), describes the role of central banking in India in the 1960’s:

“India has consciously chosen a policy of planned economic development....The traditional objective of a central bank is the maintenance of price and exchange stability. However, this is but a means to achieve economic progress rather than an end in itself. In the context of the developing countries, these objectives....have to be fitted into the broader and more compelling urge for furthering economic growth.....A country must have an appropriate degree of monetary expansion to meet the increasing requirements of a growing economy....The aim of a central bank in a developing country has, therefore, to be the adoption of adequate policies which aim at bringing about an appropriate degree of monetary expansion along with price and exchange stability....Further, monetary policy in such a country has also to provide for mobilization of resources to the maximum possible extent, as well as provide for the most efficient investment of the same for purposes of development.” [Bhattacharyya, 1971, pp. 1-2].

This monetary manifesto provides a rather stark contrast with that of the orthodox central bank, but does not seem that far different from the post-war practices of France, Belgium, Italy and Japan. (See Box 2)

Bhattacharyya emphasizes that monetary policy is only one part of economic policy and, as a result, the central bank cannot be an independent entity from the government, unto itself [p. 15], a statement from a central banker that would shock today’s promoters of the orthodox recipe. Bhattacharyya further notes that direct instruments of monetary control have an important place in the tool kit of monetary policy: they can protect important sectors from credit tightening and allow for more direct monitoring of credit use (ibid., p. 14]. This is a view of monetary policy that is similar to those employed by French and Japanese central bankers.

As in the case of postwar European countries, India deployed a broad set of capital and exchange controls, and, initially, controls over current account transactions as well. These complemented the mobilization and credit allocation techniques employed by the Reserve Bank and associated institutions. Bhattacharyya further notes, that price and exchange rate stability cannot be ignored, but are part of the fundamental development process. [ibid., p. 15] Since the 1970’s, India has been engaged in a process of financial liberalization. There have been several reforms of the banking and financial sectors, liberalization of interest rates and exchange controls and an external financial liberalization as well. While elements of the old regime still exist, the context within which they operate has been radically altered. [Saez, 2004]. The recent increase in economic growth in India has led some observers to hold liberalization and globalization to be responsible. Observers who agree with Amsden would suggest that it was during

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13 Saez [2004] is an important source for the material in this section.
the post-war years, where planning and credit mobilization and allocation, of which the Reserve Bank of India was a key part, that the foundation for recent growth was laid.

**Box 2: India**

India at the time of independence faced serious gaps in institutional structures for the mobilization of savings and investment. The banking system was mostly urban and short-term oriented, providing mostly working capital of a short term nature. [ibid., p. 3]. The stock market was the mechanism for raising long-term capital, but, like most stock markets, these rationed out new firms. Thus, “it was only natural that the Reserve Bank of India…turned its attention at the very outset, to the development of various types of new institutional facilities to fill in the gaps. This became one of its main roles in pursuance of the broader objective of the promotional aspect of central banking policy”. [ibid., p. 3]. The Reserve Bank had to establish agricultural co-operative banks, helping with raising funds and providing technical assistance; in the industrial field, the Reserve Bank helped to set up the Industrial Finance Corporation of India, which was intended to supply long-term capital needs of industry; the Reserve Bank also contributed substantially to the capital structures of various State Finance Corporations which were supposed to support the financial needs of the small industrial sector. In 1964, it also set up the Industrial Development Bank of India as a wholly-owned subsidiary of the Reserve Bank to “function at the apex of an integrated structure of industrial finance as well as to provide resources for large-sized projects of industrial development…” [ibid., p. 5]. The Reserve Bank also promoted branch banking to mobilize savings, and developed a system of industrial subsidies and preferences for targeted industries. [ibid, pp. 6-8].

In China, until recently, the central bank has been entirely subsumed into the state planning apparatus. The banking industry has been entirely state owned since the revolution, and is highly concentrated. The Chinese economy has been characterized by exchange and capital controls, as well as strong controls over interest rates and financial markets. [Saez, 2004; Epstein, et. al., 2005a]. Since the late 1970’s, this system has undergone steady reforms along with the increased role of markets, private investment and foreign investment in the Chinese economy. (See Box 3)

Maintaining a low value of the exchange rate has been a crucial component of China’s development strategy and capital and exchange controls have been a crucial component of that strategy. More recently, as interest rates, financial markets and capital controls have become more liberalized the People’s Bank of China has begun to take on more traditional macroeconomic roles typical of “modern” central banks. Still, it relies heavily on credit controls to conduct monetary policy, as it attempts to keep the Renminbi at an undervalued level for purposes of export promotion. The central bank’s management of these exchange controls has been amongst its most important developmental contribution in the last several decades.
Box 3: China

From 1949 until the late 1970s, China was dominated by one bank: the People’s Bank of China (PBOC). Its role was to help mobilize and allocate savings in accordance with the state plan. In the late 1970’s the government started to reform the banking system. By the early 1980’s the PBOC was separated from the Ministry of Finance and its monopoly position was ended. Eventually, four major commercial banks were created, all state owned. Competing with the four state banks is a second tier of state owned commercial banks. A third tier includes shareholding smaller regional banks, many of which were established as part of the special economic zones that led economic reforms in the 80’s and early 90’s. In addition, since 1994, there have been three policy banks: the State Development Bank, the Export Import Bank and the Agriculture Development Bank. These banks handled policy related lending to in association with government plans. In addition to these banks, China has a series of urban and rural cooperative banks. [Saez, ch. 15]. Finally, there are a series of non-bank financial institutions, including insurance agencies, credit unions and savings and loans. The presence of private and foreign banking in China is still marginal. [Saez, p. 31].

One of the important features of Chinese banking has been its close association with state owned enterprises (SOEs). This has now become a source of significant banking problems, with large numbers of non-performing loans connected with these SOE’s. Among the major issues facing the financial sector is the management of these non-performing loans and the reform of the SOEs. The interpretation of these loans and the role of SOE’s in China’s development is highly contested. Some argue that these indicate large scale waste, inefficiency and corruption. Li, argues, on the other hand, that these SOE’s were much more efficient than is generally realized and have played a significant role in China’s industrial development and stabilizing aggregate demand. Given China’s phenomenal industrial success and the large role of SOEs in the Chinese Economy, it would hard to make a case that they played no role in China’s stunning development.

The Chinese central bank was created out of the People’s Bank of China (PBOC) in 1983. The PBOC acted primarily as an agent of the government’s plan and did not exert a significant independent effect on policy. As such, the Central Bank is best seen as a supporter of the overall plan and of credit allocation that accompanied China’s post war growth, including the strengths as well as the weaknesses of those developments.

5.2.2 South Korea and Brazil

South Korea and Brazil both had central banks that were tied to the requirements of government and the requirements of industry. (see Boxes 4 and 5)

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As we saw in our discussion of Amsden’s work, crucial to South Korean postwar success as one of the “rest” was a strong planning and control mechanism combined with institutions to channel long term resources to targeted infrastructure and productive industrial uses. As part of this mechanism, the government retained strong controls over the financial system, particularly in the period 1961-1979 [Nembhard, 1996, p. 90]. As one economist put it, “Except for in times of war, only a few nations have used policies of selective credit control as widely and thoroughly as has Korea.” [quoted in Nembhard, p. 91]. The government used the banking system to channel credit by setting low interest rates on loans to targeted borrowers, and directing loans to particular enterprises. Amsden emphasized that monitoring and performance requirements were associated with these loans. The government used “policy loans” to direct lending for preferred purposes. Lending rates and lending conditions were strictly controlled according to the type of preferential fund. This allowed the government to effectively ration credit for certain purposes and ensure a plentiful supply for others.

What was the role of the central bank in South Korea’s development miracle? The Minister of Finance supervised and regulated all the activities of the banking system, including the central bank (the Bank of Korea). As in France and China, the South Korean central bank was subservient to these planning institutions and performed its assigned roles which evolved over time. Although the central bank was established with some degree of independence under the guidance of two experts from the New York Federal Reserve in the 1950’s, the Bank was quickly put under the de facto control of the Ministry of Finance, until this subservience was formally enshrined in legislation in 1962. [Maxfield, 1997, p. 113. At that time, the powers of the Bank were divided up among a number of entities, and the Bank of Korea itself was left only with credit policy. “This left a central bank that over the next several decades did little more than implement credit policies in line with policies designed by the Economic Planning Board and the Ministry of Finance. In fact, the bank was commonly called the ‘Namdaemun branch of the finance Ministry’ referring to the Seoul district in which the bank is located.” [Maxwell, 1997, p. 113] Over the two decades following, the central bank remained politically weak. The Bank oversaw the commercial banks’ implementation of credit distribution plans drawn up by the Economic Planning Board in accordance with overall industrialization goals. The government controls also limited the development of the financial sector, so a strong financial constituency did not develop to oppose the credit market policies. [ibid, p. 115]. Complementing the controls over the financial sector has been an extensive set of exchange and capital controls [Nembard, pp. 85-92.]. These controls allowed the Korean government to keep interest rates low when they wanted to and to allocate credit to desired purposes without much spillage overseas. They also helped to prevent financial instability at a macro level arising from unstable inflows and outflows of capital, and from excessive short-term borrowing.

As with other countries, in the 1990’s, South Korea liberalized its financial system, eventually leading to the crisis of the late 1990’s. Since that time, the Bank of Korea has
been much more preoccupied with overall macroeconomic policy, and has had fewer tools and less of a mandate to act as an agent of development.

Brazil presents an interesting contrast with South Korea. Like in South Korea, Brazil's central bank was part of a developmental apparatus that was directed at promoting growth and development. But because of insufficient planning coherence, their use of the financial apparatus was not as successful as was the case in South Korea (see Box 5).

**Box 5: Brazil**

Like many European central banks, the Brazilian Central Bank started off as a private bank, the Banco do Brasil, which in the early 1900s financed coffee growers and industrialists. [Maxfield, p. 123]. Over the 1920's, Banco do Brasil became a quasi central bank, continuing its policies of supporting these same sectors. British creditors preferred to have a “real” central bank that was not so tied to domestic borrowers, but the political power of the coffee growers and industrialists prevented the creation of a central bank to the creditors liking. A half-way institution, the Superintendency of Money and Credit (SUMOC) was created in 1945 to manage foreign exchange and credit, while the Banco du Brasil continued to actually make exchange rate and credit policy. It was also the recipient of legal mandatory reserves by commercial banks, but was exempted from having to keep them itself. Hence, it was privileged, as, we have seen, were previous central banks in their early years, despite being profit oriented. The political battles over the creation of a full, public central bank continued and a central bank was not formally created until the military coup of 1964. But as soon as it was created, its independent authority was undermined and the central bank of Brazil was brought under the close authority of the central government. [Maxfield, p. 136].

In this context, the Brazilian central bank has been tasked with implementing central government policy. This policy itself has varied over time. When the government was focused on reducing inflation (1965-1967) the government pursued more liberal and outward oriented policies. When the government wanted to encourage rapid industrialization (1950’s, 67-74, 85-87) more inward oriented policies were pursued and the central contributed in classic fashion, helping to direct finances and favored treatment to local industries, while implementing strict controls on inflows and outflows of capital. [Nembhard, p. 145].

Yet, the implementation of these policies were not nearly as effective as in the case of South Korea. There were many factors at play. Among the most relevant for our purposes was the highly decentralized nature of the country’s financial system, which made it difficult for the central bank and related institutions to monitor and control the allocation of credit. Thus, while the central bank, under the direction of the government, tried to act as an agent of development, the relative lack of a coherent planning process and the difficulties dealing with a more dispersed financial system, meant that it was not as successful as industrial policy in South Korea. [Nembard, ch. 5].
5.2.3 Thailand and Mexico

The cases of Thailand and Mexico present an interesting contrast with China, India, South Korea and Brazil. [Maxfield, 1994; 1997]. In these cases, relatively strong and independent private financial systems, along with a stronger need to borrow from foreign creditors, led both domestic and foreign creditors to support the creation of relatively independent central banks. [Maxfield, 1994].

Box 6: Thailand and Mexico

In Thailand and Mexico, the central banks were much less closely tied to financing industry and the governments than in the cases of China and India, or Brazil and South Korea. And while their positions changed over time depending on both domestic and political factors, over all, these central banks played a larger role in attracting credit from abroad and supporting the domestic financial sectors, than they did in promoting industrialization. In the 1990’s for example, in the case of Thailand, the central bank and the government supported efforts to make Bangkok into a regional financial center as part of development plan, reminiscent of the roles of the Federal Reserve and Bank of England. [Ghosh and Chandrasekhar, 2001]. With the crash of 1997, the result was not a happy one, however.

Arguably, then, these central banks were more oriented to finance and to international creditors than to domestic industrial development, and, therefore, these central banks did not act as much as agents of development as had been the case in the other countries.

In short, as the cases of Mexico and Thailand show, not ALL developing countries had strong, development oriented central banks. When central banks were too closely tied to finance and not closely enough tied to industry, they did not play the developmental role many other central banks played. The Thai and Mexican cases indicate both that not all developing countries have had developmental central banks that use the financial sector for developmental purposes. They also plausibly suggest that countries that have not had developmental central banks have paid a developmental price.

5.3 Implications

The mobilization, allocation and monitoring of medium- and long-term credit was crucial in the success of the newly industrialized economies in the postwar period. However, the role of central banking in supporting these policies varied from country to country, as a function of an array of complex factors, including inherited financial and industrial structures, the need for international finance, and various idiosyncratic factors that affected the politics of central banking. The wealth of case studies shows that developmental central banks are not empirically anomalous. In some countries, such as China, India, and South Korea, conditions were ripe for central banks to play a key role as agents of development. In others, such as Brazil, the central bank played its role, but the overall structure was highly imperfect. In others, such as Thailand and Mexico, the central bank was not as firmly a part of the planning apparatus, and tended to be more
oriented to the needs of the domestic and international financial interests than to that of the government or industry. In all cases where central banks played a crucial role, their connection with the state, with credit allocation and their use of capital and exchange controls to manage the international sector were absolutely critical to their success. This is hardly following the recipe of an independent central bank of the sort envisioned by orthodox economists.

6. The External Financial Sector and Pro-Poor Growth: A Consideration of Policy Options

There is evidence from a variety of countries that well-designed policies to manage international private capital flows have played important roles during crucial periods in the development process. We term such policies “capital management techniques,” following Epstein et al., [2004]. Capital management techniques include (but are not limited) to measures that manage the volume, composition, or allocation of capital flows and/or maintenance of restrictions on investor entrance or exit opportunities. Nearly all developed countries utilized capital management techniques successfully over long periods. For example, continental European countries employed extensive capital management techniques during the economic reconstruction that followed World War II. Even the USA—arguably the home of free capital flows, and also a country whose financial system has benefited importantly from the receipt of flight capital from around the world—used temporary capital management policies in 1963 because they were warranted by economic circumstances.

Capital management techniques played critically important roles during the high-growth eras of Japan and South Korea and were successfully employed in Brazil in the 1950s and 60s. (e.g., Nembhard, 1996). Chile and Colombia successfully used capital management techniques during the 1990s. The Malaysian government successfully employed stringent capital management policies in 1994 and 1998. India, Singapore, China, and Taiwan ROC employed diverse strategies that could be termed (even if not by the government itself) capital management techniques during the 1990s.

We argue that this is a propitious moment for advocates of pro-poor growth strategies to consider the role that capital management techniques can play in supporting pro-poor growth strategies. As we will see, some types of capital management techniques have a proven track record, not just in the decades that followed WWII, but in the current environment as well. This latter fact is increasingly recognized today, even by many prominent economists and the IMF [eg., Prasad et al., 2003] who have recently written rather positively—though nevertheless cautiously—about the role of certain types of market-based, temporary capital management techniques.

Another reason why this is a propitious moment for advocates of pro-poor growth to consider capital management techniques is that the problems associated with unfettered international private capital flows have become quite obvious, particularly in light of the financial crises in the developing world during the 1990s. And finally it must be said that a pro-poor growth agenda simply cannot succeed absent some type of management of
international capital movements. Capital management techniques are not an end in themselves. Rather they are a critical supporting player in a broader financial landscape in which the domestic financial system mobilizes and channels domestic savings with the support of a developmentalist central bank.

At this point it is important to recall the three general points that we made in connection with our discussion of policies toward the domestic financial sector (see section 4 of this module). Our earlier comment on nationally-specific policies is relevant to this discussion of international capital flows insofar as policies designed to manage certain types of international private capital flows are relevant to some countries, and not to others. We know that for many developing countries the problem of how to manage excessive PI and FDI inflows is a mere dream because they attract little to none of these flows in the first place. For some developing countries, private remittances are extremely important as a source of external finance, whereas for others this is not the case.

With regard to our earlier discussion of dynamic financial policies, it is worth mentioning here Grabel’s [2004] proposal that developing countries implement a system of dynamic, narrowly targeted, and transparent capital management techniques that policymakers activate gradually once particular types of financial vulnerabilities are identified. There are certainly circumstances under which more-or-less static capital management techniques are appropriate. However, there are national environments where dynamic capital management techniques can be useful and feasible. In such environments, capital management techniques are activated whenever information about the economy indicates that such policies are necessary to prevent nascent macroeconomic fragilities from culminating in serious difficulties or even in a crisis. There are two tools envisioned in this approach--“trip wires” and “speed bumps.” Trip wires are simple measures that warn policymakers and investors that a country is approaching high levels of risk in various domains (e.g., currency collapse, the flight of foreign lenders or investors, the emergence of fragile financing strategies, etc.). Once a trip wire predicts the emergence of a particular vulnerability, policymakers would then immediately take steps to curtail this risk by activating a targeted, graduated capital management technique, termed a speed bump. Developing countries at different levels of wealth require distinct trip-wire thresholds. Trip wires would have to be appropriately sensitive to subtle changes in the risk environment and adjustable. Sensitive trip wires would allow policymakers to activate graduated speed bumps, well before conditions for investor panic had materialized. (See sections 6.1-6.2 of this module for specific examples).

We divide our discussion of policy options toward private international capital flows into several sections—policies toward foreign bank borrowing (section 6.1), PI (section 6.2), FDI (section 6.3) and private remittances (section 6.4).\(^{15}\) Our discussion of these diverse types of private international capital flows is motivated by the view that appropriate capital management techniques can increase the likelihood that different types of international capital flows support--and certainly do not disrupt--a pro-poor growth

\(^{15}\) Note that sections 6.1-6.3 and 6.5 draw heavily on Chang and Grabel [2004: ch. 9, 11] except where noted.
agenda. The attraction of any type of private international capital flows should not be seen as a panacea by policymakers (and accordingly, we do not describe policies to attract private international capital flows). Rather, the question is how can appropriate capital management techniques maximize the developmental potential of these flows. Section 6.5 presents a brief discussion of the complementarity between efforts to manage the exchange rate and international private capital flows. A thorough treatment, of strategies toward the exchange rate is, of course, outside the scope of this module.

Tables 5 and 6 summarize many of the key aspects and impacts of the capital management techniques employed by a range of developing countries during the 1990s [from Epstein, Grabel and Jomo, 2004]. These tables complement the discussion below by giving quite specific and concrete country experiences to illustrate the general points about capital management techniques in the discussion that follows.

**Table 5**
*Experiences with Capital Management Techniques in the 1990's*

<table>
<thead>
<tr>
<th>Country</th>
<th>Types of Capital Management Techniques</th>
<th>Objectives of Capital Management Techniques</th>
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<tbody>
<tr>
<td>Chile</td>
<td>Inflows</td>
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<td>Inflow management</td>
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<td>FDI and PI: One year Residence Requirement</td>
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<td>30% URR</td>
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<td><strong>Borrowing Restrictions:</strong></td>
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<td></td>
<td>Tax on foreign loans: 1.2% per year</td>
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<td><strong>Outflows:</strong> No Restrictions</td>
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<td></td>
<td><strong>Domestic financial Regulations:</strong></td>
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<td></td>
<td>-Lengthen maturity structures and stabilize inflows</td>
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<td>-help manage exchange rates to maintain export competitiveness</td>
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<td>-protect economy from financial instability</td>
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<td>Colombia</td>
<td>Similar to Chile</td>
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<td>Taiwan</td>
<td>Inflows</td>
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<td>-bank accounts can only be used for domestic spending, not financial speculation</td>
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<td>-foreign participation in stock market regulated</td>
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<td>-FDI tightly regulated</td>
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<td>residents</td>
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<td>regulation of foreign borrowing</td>
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<td><strong>Outflows</strong></td>
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<td><strong>Domestic Financial Regulations</strong></td>
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<td>-restrictions on lending for real estate and other speculative purposes</td>
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<td>-Promote industrialization</td>
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<td>-Help manage exchange for export competitiveness</td>
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<td>-Maintain financial stability and insulate from foreign financial crises</td>
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<td>Country</td>
<td>Inflows</td>
<td>Outflows Non-residents</td>
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<td>Singapore</td>
<td>&quot;Non-Internationalization&quot; of Singapore $ inflows</td>
<td>- Financial institutions can't extend $ credit to non-residents if they are likely to use for speculation</td>
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<td><strong>Outflows</strong></td>
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<td>- 12 month repatriation waiting period</td>
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<td>- Graduated exit levies inversely proportional to length of stay</td>
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<td>Malaysia</td>
<td>Inflows</td>
<td>- Restrictions on foreign borrowing</td>
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<td>India</td>
<td>Inflows Non-residents</td>
<td>Strict Regulation of FDI and PI</td>
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<td>residents exchange controls</td>
<td>from financial contagion</td>
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</tr>
<tr>
<td><strong>Domestic Financial Regulations</strong></td>
<td>-preserve domestic savings and forex reserves</td>
<td></td>
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<tr>
<td>-strict limitations on development of domestic financial markets</td>
<td>-help stabilize exchange rate</td>
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</tbody>
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<table>
<thead>
<tr>
<th>China</th>
<th><strong>Inflows</strong> non-residents</th>
<th><strong>Outflows</strong> non-residents</th>
<th><strong>Domestic Financial Regulations</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-strict regulation on sectoral FDI investment</td>
<td>-no restrictions on repatriation of funds</td>
<td>-strict limitations on residents and non-residents</td>
</tr>
<tr>
<td></td>
<td>-regulation of equity investments: segmented stock market</td>
<td>-strict limitations on borrowing Chinese Renminbi for speculative purposes</td>
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</table>

**residents exchange controls**

**Domestic Financial Regulations**
-strict limitations on residents and non-residents
-support industrial policy
-pursue capital account liberalization in incremental and controlled fashion
-insulate domestic economy from financial contagion
-increase political sovereignty
-preserve domestic savings and foreign exchange reserves
-help keep exchange rates at competitive levels


*This description applies to the experience during the 1990's and not necessarily in the current period.*
### Table 6:
**Effects of Capital Management Techniques in Seven Cases**

<table>
<thead>
<tr>
<th>Country</th>
<th>Achievements</th>
<th>Supporting Factors</th>
<th>Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chile</td>
<td>- Altered composition and maturity of inflows</td>
<td>- Well designed policies</td>
<td>- Higher cost of capital for small firms</td>
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<tr>
<td></td>
<td>- Reduced vulnerability to contagion</td>
<td>- Offered foreign investors good returns</td>
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<tr>
<td></td>
<td></td>
<td>- State capacity</td>
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<tr>
<td></td>
<td></td>
<td>- Flexible application</td>
<td></td>
</tr>
<tr>
<td>Colombia</td>
<td>- Similar to Chile but less successful</td>
<td>- Less state capacity than Chile</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Less flexible</td>
<td></td>
</tr>
<tr>
<td>Taiwan POC</td>
<td>- Kept debt load manageable</td>
<td>- Strong state capacity</td>
<td>- Possibly contributed to a less developed financial sector</td>
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<tr>
<td></td>
<td>- Help to keep competitive exchange rate</td>
<td>- Strong economic fundamentals</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Insulated from financial crises</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Helped to maintain economic sovereignty</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Singapore</td>
<td>- Insulated from disruptive speculation</td>
<td>- Public support for policies</td>
<td>- Possible cronyism/corruption</td>
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<tr>
<td></td>
<td>- Helped manage soft peg</td>
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<td></td>
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<tr>
<td></td>
<td>- Contribute to financial strength</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>- Facilitated macroeconomic reflation</td>
<td>- Public support for policies</td>
<td>- Possible cronyism/corruption</td>
</tr>
<tr>
<td></td>
<td>- Helped to maintain domestic economic sovereignty</td>
<td></td>
<td></td>
</tr>
<tr>
<td>India</td>
<td>- Facilitated incremental liberalization</td>
<td>- Strong state and bureaucratic capacity</td>
<td>- Restricted the development of the domestic financial sector</td>
</tr>
<tr>
<td></td>
<td>- Insulated from financial contagion</td>
<td>- Strong public support</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Helped preserve domestic saving</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>- Helped to maintain economic sovereignty</td>
<td></td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>- Facilitated industrial policy</td>
<td>- Strong state and bureaucratic capacity</td>
<td>- Constrained the development of the financial sector</td>
</tr>
<tr>
<td></td>
<td>- Insulated economy from financial contagion</td>
<td>- Strong economic fundamentals</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Helped to preserve savings</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Helped to manage exchange rate and facilitate export led growth</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>- Helped to maintain expansionary macro-policy</td>
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<td></td>
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<tr>
<td></td>
<td>- Helped to maintain economic sovereignty</td>
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6.1 Policies toward Foreign Borrowing

It is critical that developing countries drastically reduce their reliance on foreign bank loans since repayment pressures have strangled economic growth and seriously harmed the poor in so many countries. It would therefore be of significant benefit if policymakers enforced strict ceilings on the volume of new foreign loans that can be incurred. Such ceilings might involve strict limits on the allowable ratio of foreign to total loans, or might require that firms finance only a certain percentage of their projects with foreign loans that have a certain maturity and/or locational profile.

Restrictions on foreign lending could be deployed dynamically as circumstances warrant, following the trip wire-speed bump approach. Under this approach, policymakers would monitor a trip wire that measures the economy’s vulnerability to the cessation of foreign lending. This involves calculating the ratio of the government’s holdings of currency reserves to private and public foreign-currency denominated debt (with short-term obligations receiving a greater weight in the calculation). If this ratio approached an announced threshold, policymakers would then activate a graduated speed bump that precluded new inflows of foreign loans until circumstances improved.

Policy can also discourage—rather than prohibit—the use of foreign loans as a source of finance. The tax system can be used in a number of ways to discourage domestic borrowers from incurring foreign debt obligations. Domestic borrowers might pay a fee to the government or the central bank equal to a certain percentage of any foreign loan undertaken. This surcharge might vary based on the structure of the loan, such that loans that involve a locational or maturity mismatch incur a higher surcharge. Alternatively, the surcharge might vary based on the level of indebtedness of the particular borrower involved, such that borrowers who already hold large foreign debt obligations face higher surcharges than do less-indebted borrowers. This tax-based approach could encourage borrowers to use domestic sources of finance since these would not carry any surcharge. Another strategy might involve varying the surcharge according to the type of activity that was being financed by foreign loans. For instance, borrowers might be eligible for a partial rebate on foreign loan surcharges when loans are used to finance types of production that are highly employment intensive.

Note that policymakers in Chile and Colombia employed tax-based policies to discourage foreign borrowing during much of the 1990s. In Chile, foreign loans faced a tax of 1.2% per year (payable by the borrower). Chilean policymakers also imposed a non-interest bearing reserve requirement of 30% on all types of foreign debts (and indeed, on all foreign financial investments in the country). This policy, termed the reserve requirement tax, was in place from May 1992 to October 1998. The required reserves held against foreign obligations (and payable by the borrower) were kept at the Central Bank for one year, regardless of the maturity of the obligation. Authorities in Colombia

\[16\] Maturity mismatch occurs when borrowers finance long-term obligations with short-term credit, leaving them vulnerable to changes in the supply and cost of credit. Locational mismatch occurs when borrowers contract debts that are repayable in foreign currency, leaving them vulnerable to currency depreciation that increases the cost of debt service.
also employed a reserve requirement tax specifically designed to discourage domestic borrowers from incurring foreign loans. Beginning in September 1993, Colombian policymakers required that non-interest bearing reserves of 47% be held for one year against foreign loans with maturities of eighteen months or less (this was extended to loans with a maturity of up to five years in August 1994). In addition, foreign borrowing related to real estate transactions was prohibited. Empirical studies of Chilean and Colombian policies conclude that they achieved their principal objectives, including the reduction in foreign borrowing [see Grabel, 2003a, and references therein].

To the extent that borrowers assume at least some foreign loan obligations, it is imperative that the allocation and terms of these loans be managed by the government. Careful management of the allocation of foreign debt can ensure that it is used for productive, developmental purposes. Prior to financial liberalization in the 1990s, many governments in East and Southeast Asia tightly coordinated allocation and access to foreign loans. Until quite recently, policymakers in China and India maintained tight restrictions on foreign borrowing through a variety of means [for details, see Epstein, et al. 2004]. For example, domestic Chinese firms were required to obtain government approval for any foreign loans undertaken. The Indian government maintained firm restrictions over the level and terms of the external debts held by domestic firms. Responding to the lessons of the 1997 Asian crisis, India restricted commercial borrowing in foreign currencies. The Ministry of Finance still maintains annual ceilings on the size and interest rate on loans sought by domestic firms. The Ministry also rules on requests for foreign loans on a case-by-case basis, making this determination based on the maturity structure and end-use of the proposed loan. In the approval process, priority is given to longer-term loans and loans for priority sectors. Firms in China and India have low levels of external indebtedness and external financial fragility precisely because of government policies toward external debt.

In general, policymakers should implement measures that restrict or otherwise discourage domestic borrowers from using financing strategies that involve locational and maturity mismatch. In addition to the ceilings, surcharges or approval processes discussed above, policymakers can design trip wires and speed bumps that are designed to keep the levels of maturity and/or locational mismatch below the critical thresholds. A trip wire for locational mismatch is the ratio of foreign-currency denominated debt to domestic-currency denominated debt (with short-term obligations receiving a greater weight in the calculation). A trip wire for maturity mismatch is the ratio of short-term debt to long-term debt (with foreign-currency-denominated obligations receiving a greater weight in the calculation). A graduated series of speed bumps that require borrowers to reduce their extent of locational or maturity mismatch would be implemented whenever trip wires revealed the early emergence of these vulnerabilities.

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17 Note that the level, scope and method of paying the reserve requirement tax was, in fact, changed many times during the lifespan of the policy regime in both Chile and Colombia. See Grabel [2003a] for details and Epstein, Grabel and Jomo [2004].
In those cases where foreign loans have been significant, economic reforms that promote growth could replace the resources initially lost if there is a reduction in foreign borrowing due to the measures described above. Governments and central banks that take steps to restrict foreign borrowing can replace at least some of the finance that is forgone by implementing measures that increase their ability to mobilize and channel domestic saving to projects that are central to a pro-poor growth agenda. In this connection, measures that restrict the exit options of domestic savers and businesses would increase the pool of capital available domestically (since so much of it is presently lost to capital flight, see section 6.2 of this module). The coordination of industrial policy and domestic financial regulation can also ensure that domestic firms have access to capital that is generated domestically. Tax reform is yet another means of increasing the domestic resource base. More generally, a multi-faceted pro-poor growth agenda will generate higher levels of investment and economic growth over time. If this approach is successful, the economy in the medium- to long-term will generate new domestic resources that can be used to finance additional investment.

6.2 Policies toward Portfolio Investment

Management of PI warrants serious consideration. Various types of management techniques have contributed importantly to economic development in a range of countries. Careful management of PI can maximize the benefits and minimize the costs associated with this resource. Many countries successfully regulated PI for extended periods of time. For instance, during the two decades that followed WWII, all industrialized countries heavily regulated PI inflows and outflows [Helleiner, 1994]. The only exception was the USA, but even it resorted to temporary management of PI for a short time in the 1960s when policymakers sought to enhance confidence in the country’s faltering economy. Indeed, most Continental European countries and Japan maintained stringent management of portfolio and other capital flows until the mid-1980s.

The use of capital management techniques was not confined to wealthy countries. Management of PI was the norm in developing countries until orthodoxy in economic policy attained prominence. By any reasonable account, management of portfolio and other capital flows contributed importantly to the success of numerous developing countries during the era of their strongest economic performance, namely, the period between the 1950s and the mid-1970s. Compared to the orthodox era, developing countries as whole witnessed impressive economic performance during the three decades that followed WWII, a time when capital management techniques were used rather widely. Management of capital movements (in addition to industrial and trade policy) contributed significantly to the strong economic performance of many East and Southeast Asian countries during the 1970s and 80s.

Some developing countries continue to use (or have recently used) techniques to manage PI in the service of important objectives. And even in the current climate, a few large developing countries--some until quite recently--effectively utilize techniques to manage PI inflows and outflows. Here, we identify recent examples of such strategies.
Malaysian authorities twice imposed restrictions over PI during the 1990s. The first such effort was in early 1994. At that time, the Malaysian economy received dramatic increases in the volume of private capital inflows (including, but not limited to, PI). Policymakers were concerned that these inflows were feeding an unsustainable speculative boom in real estate and stock prices and were creating pressures on the domestic currency. In this context, policymakers implemented stringent, temporary inflow capital management policies. These measures included restrictions on the maintenance of domestic currency-denominated deposits and borrowing by foreign banks, management of the foreign exchange exposure of domestic banks and large firms, and prohibitions on the sale of domestic money market securities with a maturity of less than one year to foreigners.

Reaction to these measures was rapid and dramatic, so much so that authorities were able to dismantle them as planned in under a year (as they achieved their goals during this time). During the period that the capital management techniques were in place, the volume of net private capital inflows and short-term inflows fell sharply, the composition of these flows was altered significantly, pressure on the currency was reduced, and the inflation of stock and real estate prices was curtailed [Palma, 2000]. The immediate, powerful reaction to these temporary capital management policies underscores the potential of speed bumps to stem incipient difficulties successfully.

The Malaysian government again implemented stringent management of capital inflows and outflows in 1998 during the East Asian financial crisis. This effort involved restrictions on foreign access to the domestic currency, on international transfer and trading of the currency, and on the convertibility of currency held outside of the country. The government also established a fixed value for the domestic currency, closed the secondary market in equities, and prohibited non-residents from selling local equities held for less than one year.

By numerous accounts, these rather stringent measures prevented the further financial implosion of the country – a notable achievement since the country was also gripped by a severe political and social crisis during this time. Comparing the situation of Malaysia to other countries that were party to the Asian crisis, studies find that the country’s capital management techniques were responsible for the faster recovery of its economy and stock market as well as the smaller reductions in employment and wages [Kaplan and Rodrik, 2001]. The latter achievements were possible because capital management techniques provided the government with the ability to implement reflationary economic and social policies uninhibited by the threat of additional capital flight or IMF disapproval.

From 1992 to 1998, policymakers in Chile and Colombia regulated PI rather extensively and successfully. During that time, the Colombian government did not allow foreign investors to purchase debt instruments or corporate equity. This policy was designed to prevent the possibility that financial instability could be induced by the sudden exit of foreign investors from liquid investment holdings. However, there were no significant capital management techniques that focused on FDI. The differential treatment of FDI and PI was intended to promote the type of foreign investment that the government
deemed important to economic growth, while protecting the economy from destabilizing forms of investment.

The Chilean government had similar motivations for its policy toward foreign investment in the country. By using the reserve requirement tax of 30% on foreign investment, the government sought to lengthen the time horizon of investment and encourage more stable forms of foreign investment. FDI and PI faced a one-year residence requirement. The government also prevented pension fund managers from investing more than 12% of their assets abroad. This policy was intended to curb the possibility of capital flight by the most important type of large domestic investor.

Numerous empirical studies conclude that capital management techniques in Chile and Colombia played a constructive role in changing the composition and maturity structure (though not the volume) of net capital inflows, particularly after capital management techniques were strengthened in 1994-5 [see Grabel, 2003c, and references therein]. Following implementation of these policies in both countries, external financing in general moved from debt to FDI. Policymakers in both Chile and Colombia were able to implement growth-oriented policies because the risk of foreign investor flight was significantly curtailed by their capital management techniques. Finally, the macroeconomic stability fostered by these management techniques contributed to the financial stability experienced by Chile and Colombia following the Mexican and the Asian financial crises. For instance, while other countries in Latin America were devastated by these events (due to the exit of investors from equity and government bond markets), Chile remained largely stable and only began to experience a significant reduction in private capital inflows in August 1998.

In the case of China, up until the gradual move to liberalize international financial flows that began a few years ago, the participation of foreigners in equity markets was limited very strictly, and the activities of its largely state-owned banks were circumscribed (e.g., lending to foreigners for certain kinds of projects was tightly regulated and access to foreign currency severely restricted). Chinese residents also faced obstacles to capital expatriation. In fact, the Chinese government tightened restrictions and introduced new techniques to manage finance following the Asian crisis. As the crisis unfolded, the Chinese government announced new restrictions on foreign exchange transactions involving more than $100,000, introduced new measures making it more difficult for domestic and international companies to move money into and out of the country, and introduced strict new penalties on Chinese companies that maintained illegal foreign currency deposits overseas. Similarly, during the Asian financial crisis, authorities in Taiwan POC also took steps to prevent illegal trading of funds managed by George Soros (because these funds were blamed for causing the local stock market to fall).

There is a strong case for restricting the access of domestic savers to foreign capital markets. The flight of domestic investors can induce financial instability, and reduce the tax base and the pool of domestic savings available for allocation by domestic financial institutions. For these reasons, there is a strong case for restricting the ability of domestic investors to hold foreign savings accounts and engage in capital flight.
In the mid-1980s, despite being the fourth largest foreign debtor in the world, Korea was saved from a debt crisis partly because of stringent management of capital outflows. China and India provide more recent examples. China maintained firm restrictions on the ability of domestic investors to engage in foreign PI until a few years ago (by limiting their access to foreign currencies in the first place). India, too, has been gradually loosening its traditionally firm management of international financial flows over the last few years. Prior to liberalization, the exit options of domestic investors were tightly restricted via limitations on their access to foreign currency. Indian residents and firms were simply precluded from maintaining foreign currency accounts abroad, and Indian banks could not accept deposits or extend loans in foreign currencies. Recent studies have shown that the combined effects of restrictions on capital flight, currency speculation, and access to foreign currency and loans protected China and India from instability during the Asian financial crisis.

The discussion above suggests that there are several directions for managing PI. The success of blunt restrictions on PI in China, India, Chile and Colombia suggest that foreign investors do not necessarily shun countries with minimum-stay requirements on foreign investment or other types of capital management techniques. We have also seen that the tax system can be used to influence the composition and/or maturity structure of international capital flows. The potential for flight by domestic investors and savers can be reduced via implementation of exit taxes, prohibitions on flight, or restrictions on access to foreign currencies. Finally, Malaysian experience suggests that speed-bump style management of PI can be effective as well.

The trip wire-speed bump approach lends itself to the design of temporary management of PI. A trip wire that would reveal the vulnerability to PI flight risk is the ratio of total accumulated foreign PI to gross equity market capitalization or gross domestic capital formation. If the trip wire revealed that a country was particularly vulnerable to the reversal of PI inflows, a graduated series of speed bumps would slow the entrance of new inflows until the ratio falls either because domestic capital formation or gross equity market capitalization increased sufficiently or because foreign PI falls. Thus, a speed bump on PI would slow unsustainable financing patterns until a larger proportion of any increase in investment could be financed domestically. We emphasize the importance of speed bumps governing inflows of PI because they exert their effects at times when the economy is attractive to foreign investors, and so are not as likely as outflow restrictions to trigger investor panic. Though not a substitute for outflow management, inflow restrictions also reduce the frequency with which they must be used, and their magnitude.

6.3 Policies toward FDI

Foreign Direct Investment (FDI) is a type of financial flow and therefore is highly relevant to a module on financial policy. At the same time, FDI can also be more than a financial flow: it can arrive along with a package of technology, access to international markets, and expertise in sales and production. FDI can come in two general forms: as a so-called "Greenfield" investment, where new plant and equipment are associated with
FDI; or it can arrive as part of a merger and acquisition (M&A), where a foreign investor buys more than 10% of the equity of a domestic firm (so-called "brownfield" investment).

FDI is seen as a highly desirable form of international investment by many developing countries because governments often see it as: 1) more stable than other flows, 2) as a mechanism for bringing a great deal of net capital into the country, 3) as a vehicle for bringing new technology and expertise into the country, and 4) as a means for promoting integration with international markets.

In view of these perceived benefits, many developing countries are willing to make significant (and often costly) adjustments to domestic economic policy and institutions in order to attract FDI inflows. A key question is whether the benefits of FDI inflows offset the costs associated with the policy and institutional changes that are often undertaken to attract these inflows.

A large literature assesses the impacts of FDI on developing countries and most find that the positive impacts, in general, are smaller than many developing country governments believe (Hanson, 2001; UNCTAD, 2000). In most cases there are modest degrees of technology and skill transfer; limited degrees of employment generation; net inflows of capital are limited due to domestic sourcing of funds and profit remittances; linkages to the domestic economy are limited (this is reflected in modest increases in value added in production); and there is also some evidence that FDI flows are not significantly more stable than portfolio flows. Finally, as discussed in section 2.3 above, most countries, no matter how hard they try, can attract only very limited amounts of FDI, especially since most of flows to a relatively small number of developing countries.

Still, under the right circumstances and with the appropriate institutional structures, FDI inflows can contribute to development. An examination of historical experiences suggest the ways in which FDI as a financial inflow can be managed in a development friendly manner. (see Box 7)

**Box 7: A Developmental Approach to FDI**

Some countries, especially in East Asia, offer particularly good recent examples of strategies for maximizing the developmental benefits of FDI. Even more recently, China, India and Vietnam have adopted highly strategic attitudes toward FDI (rather than the “open door” policy in place in so many countries). The experience of this latter group of countries demonstrates that foreign investors will not necessarily shun countries that apply capital management techniques to FDI. Indeed, evidence also shows that foreign investors place more emphasis on a large domestic market, an educated workforce, rising incomes and economic growth, and sound infrastructure rather than on a liberal regulatory regime when making foreign investment decisions. Thus, policymakers in developing countries have no reason to think that low wages and lax regulation are appropriate strategies for attracting FDI.
FDI policy stands the best chance of contributing to pro-poor growth objectives if policymakers develop a clear vision as to how it contributes to the country’s overall macroeconomic aims. Countries like Korea and Taiwan POC are known to have used strict regulation on FDI in most industries, while also taking a very liberal attitude towards FDI in others. This mixture of restrictive and liberal policies was possible because the governments developed a clear FDI strategy that differentiated among industries. The recent experiences of Singapore and Costa Rica show that policymakers can target the attraction of particular types of FDI (or even target particular firms) as a central part of their overall economic strategy. The potential of different types of FDI might be parsed according to its employment multiplier.

The precise strategy toward FDI taken in any particular country should depend on the nature of the FDI that is being sought, the country’s endowments, and the growth and poverty-reduction objectives of the government. Some countries, especially the poorest ones, may have rather narrow goals for FDI, seeking only an infusion of foreign capital that will increase employment (under any terms), alleviate poverty, and attract foreign exchange. The garment industry, shoe production, and toy manufacture often function in this limited, but in some cases, economically important capacity. In such cases, it may be acceptable—or even important—that the country maintain a relatively liberal attitude toward FDI because the industries are seen strictly as a strategic means to attract foreign capital in the short run. Many countries have established export processing zones for the purpose of attracting FDI to these types of industries. However, it should be noted that the types of industries that tend to populate export-processing zones are dead ends in the long run. Therefore policymakers need to devise a strategy to reinvest the export earnings generated by such industries in order to generate new industrial capabilities.

In some countries and in some industries, the government may find it necessary to induce foreign investors to undertake expensive investments in capital equipment and technology. These types of foreign investments can sometimes be a precondition for using the country’s natural resources to some advantage because the technology or finance necessary to exploit or extract natural (e.g., mineral) resources is not always available domestically. In this context it may be necessary to adopt an FDI strategy for this sector that is attractive to foreign investors, but which nevertheless allows the host country to extract the largest possible “rent” from their own natural resources. Carefully structured joint-operating agreements have worked well in some countries.

In some cases, the government may seek to promote certain industries as part of an industrial policy plan aimed at creating long-run international competitiveness in some realm. At the early stages this might necessitate a major injection of new technology and capital, a circumstance that necessitates the participation of foreign firms. In this type of situation, it is important for the national government to negotiate with foreign firms over technology transfer and to prevent these firms from imposing restrictions on export and R&D. These matters were rather well negotiated in the cases of the Chinese auto industry and the Korean fast train project in the mid-1990s.
Finally, in those cases where the country is reasonably close to achieving international competitiveness in a particular industry, it may be necessary to exclude foreign firms altogether. This is especially important where the domestic market is small. This restriction may be necessary so that local firms have the greatest possible opportunity to develop their competitive advantage.

The main point is that there is no single appropriate strategy for all types of FDI and for all types of countries. Policies towards FDI must be tailored to the particular conditions of each industry and each country. And, as with other types of capital flows, management of FDI must be dynamic so that policy evolves as internal and external conditions change.

6.4 Policies toward Private Remittances

Researchers have only recently begun to examine the contribution of remittances to economic growth, investment, household consumption, and poverty reduction. Indeed, Solimano [2003] is one of the only studies that address these macroeconomic issues in a preliminary fashion. Rempell [2005] considers these issues in the Mexican context. At this point, there is a great deal more empirical work to be done, particularly with regard to how recipients use these funds (i.e., do they smooth consumption or promote investment) and whether they substitute for or complement savings by recipients.

There is reason to consider mechanisms that reduce the cost of sending and receiving remittances in order to increase the size of the potential remittance pool. It is also important to increase the ability of the domestic banking system in recipient countries to mobilize these funds in accordance with a pro-poor growth agenda. Some of the initiatives discussed in section 4.2 may be useful in the latter connection.

Solimano [2003] argues that on the sending-country side, banks should be encouraged to develop new low-cost product lines for migrants, such as special checking, savings or ATM accounts. On the recipient country side, he suggests several strategies. For example, governments and local financial institutions can issue interest-bearing bonds for emigrants as a vehicle for channeling remittances; housing and education accounts can be created to channel remittances to these activities in the home country; and alliances can be created between domestic banks in the receiving countries and banks in the sending countries with the goal of reducing the costs of remittances.

Rempell’s [2005] work on remittances to Mexico has relevance beyond the country. He proposes the creation of opportunities for migrant workers to remit their earnings into foreign currency accounts in domestic banks. He acknowledges that this measure alone might not reduce the cost of remittances in rural areas since large banks rarely have a presence outside of the cities. For that reason, he suggests that MFIs should become eligible to receive international transfers. He also describes an innovative program in the Mexican state of Zacateca that is designed to leverage the developmental potential of remittances. Beginning in 1992, the local government began to match (initially at a two-
for-one, and now at a three-for-one rate) monies that were sent to the state by “home
town associations” of migrants living in the USA.

6.5 A Brief Mention of the Complementarity between Managed Exchange Rates
and the Management of International Capital Flows

As noted in the introduction to this section, a discussion of strategies toward the
exchange rate is outside the scope of this module.\textsuperscript{18} There may be good reasons (indeed,
very good reasons) for countries to pursue diverse types of managed exchange rate
regimes, such as crawling or adjustable currency pegs. These approaches have played
important roles in promoting industrialization, export- and employment growth and
financial stability in many countries in the post-WWII period and in the recent era [see
discussion in Chang and Grabel, 2004: ch. 11; Williamson, 2002].

For the purposes of this module, we simply note that managed exchange rate regimes of
any type are sustainable only if supported by techniques to manage international capital
flows. This is because high volumes of international capital inflows or outflows make it
difficult for authorities to maintain any type of currency peg within a pre-determined
range. Absent the ability to maintain the exchange rate within a pre-determined range,
the best laid plans to promote export-, employment- and/or pro-poor growth and
macroeconomic stability will be compromised. Moreover, authorities will need to
maintain extremely large holdings of foreign exchange reserves to protect the currency
from a speculative attack, a circumstance that carries with it large opportunity costs.

7. Conclusions

We have argued that the financial landscape in developing countries faces serious
challenges involving excessively high real interest rates, low levels of credit creation, and
a dearth of long-term, patient capital and capital for small- and medium-sized enterprises
and the poor. The global financial landscape is also inadequate to the task of promoting
pro-growth in the developing world. Globally, financial markets are characterized by a
misallocation of savings and by the pro-cyclical nature of credit and capital flows.
We have also argued that the policies of financial liberalization that have been pursued in
many developing countries over the last quarter century have exacerbated the challenges
facing developing countries. In particular, financial liberalization often led to greater
inequality and to a stagnation of incomes and employment opportunities for the poor.

The main contribution of this \textit{Financial Training Module} is not to demonstrate the
inadequacy of developing country or the global financial landscape. Rather, the chief
contribution of this work is to demonstrate that there exists a wide range of strategies that
financial policymakers in developing countries can use to promote pro-poor growth. Of
course, financial polices alone are not a panacea for the poverty that plagues the
developing world. Moreover, the challenges associated with significant financial reform
cannot be ignored. However, it is imperative that we recognize that properly considered

\textsuperscript{18} See Chang and Grabel [2004: ch. 11] for discussion of exchange rate policy.
and nationally-specific financial policies can play an important role in providing finance for employment and in building assets by the poor, can help stabilize the macro-economy, and can enhance the economic and social power of the poor in the developing world.

We have argued that the financial sector has numerous important roles to play in promoting pro-poor growth. It can:

- Mobilize savings that can be used for productive investment and employment creation;
- Create credit for employment generation and poverty reduction at modest and stable real interest rates;
- Allocate credit for employment generation and help the poor to build assets, including in agriculture and in small- and medium-sized enterprises and in housing;
- Provide patient (long-term) credit for productivity-enhancing innovation and investment;
- Provide financing for public investment to provide for employment generation and productivity enhancement;
- Help to allocate risks to those who can most easily and efficiently bear those risks;
- Help to stabilize the economy by reducing vulnerability to financial crises, procyclical movements in finance, and by helping to maintain moderate rates of inflation;
- Help the poor by providing basic financial and banking services.

We show that there exists diverse types of financial policies and institutions that can play a useful role in promoting pro-poor growth in developing countries. In this module we described a large number of principles, policies and institutions – from earlier historical eras and from the current period that can and have promoted pro poor growth. We also describe a number of more innovative policies that we believe warrant consideration by today’s policymakers.

We found that pro-poor financial policies tended to be the most successful when they satisfied several conditions:

- They had strong monitoring mechanisms in place to increase the likelihood that they could achieve their goals
- They operated in a context of robust aggregate demand so that there was a facilitating environment for economic growth
- They also operated in a domestic and international environment in which there was not a large degree of instability; and
- They were part of a coherent overall developmental plan implemented by the government.
The main policy lessons or this module are that: 1) countries should not become excessively reliant on private foreign capital to fund their development since such capital can be unstable and unreliable, 2) market allocation of finance needs to be embedded in strong financial regulations often supplemented by an important role for government guidance of finance to important sectors, 3) there are a large variety of successful ways to use the financial system to mobilize and direct finance that make a judicious use of market incentives, government guarantees and monitoring to ensure that the finance goes to socially productive purposes and the poor 4) central banks, along with other public financial institutions need to be involved in promoting a developmental role for finance, and 5) capital management techniques, usually of a dynamic and flexible nature, can be a very important tool for reducing the negative aspects of global financial integration while enhancing the positive aspects. The overriding message of this module is that there exists a wide range of financial policies and experiences that policymakers can draw upon and adapt in accordance with their pro-poor growth objectives.
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