FINANCIAL LIBERALIZATION AND ITS DISTRIBUTIONAL CONSEQUENCES: AN EMPIRICAL EXPLORATION

A Dissertation Presented

by

ARJUN JAYADEV

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Economics

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ABSTRACT

FINANCIAL LIBERALIZATION AND ITS DISTRIBUTIONAL CONSEQUENCES: AN EMPIRICAL EXPLORATION

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Although there has been growing interest in the social impacts of financial deregulation in economies across the world, a large research gap persists. Despite voluminous literature, there has been very little empirical work addressing the distributional consequences of a liberal financial regime.

This dissertation seeks to make such an assessment. Developing a theoretical model and a new and improved index of deregulation, this dissertation uses panel data analysis to test the effects of international capital mobility on the share of labor in national income. The results suggest that capital account openness reduces the labor share of national income, thereby providing evidence for the thesis that capital mobility alters the bargaining power of labor and capital to the detriment of the former.

The cross country study is supplemented by two case studies of India and Indonesia which assess the impacts of both international and domestic deregulation on other aspects of distribution. The results suggest that despite the contrasting approaches to financial liberalization, in both economies it has considerably reduced the scope for policy makers to undertake egalitarian developmental policies and to protect vulnerable sections of society.

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CHAPTER 1

INTRODUCTION

> Those who take the most from the table, teach contentment. Those for whom the taxes are destined, demand sacrifice. Those who eat their fill speak to the hungry of wonderful times to come. Those who lead the country into the abyss, call ruling difficult for ordinary folk.
>
> The defeats and victories of the fellows at the top aren't always defeats and victories for the fellows at the bottom.
>
> Bertolt Brecht

1.1 Motivation

This dissertation is an empirical exploration of the distributional impacts of external and domestic financial liberalization. Despite an abundant literature that evaluates the various social consequences of neoliberal reforms, the effects of financial deregulation on various elements of distribution have been seriously understudied. There are many reasons for this neglect- researchers have been hampered till recently by the unavailability of comparable data on inequality, poor measures of financial liberalization, and the recency of reforms in many parts of the world .

Real world developments and advances in research have only made this gap more glaring and urgent to address. A series of devastating financial crises in regions as varied as East Asia, Latin America, Russia and Turkey in the 1990s have caused many policy makers to reconsider the dangers posed by rapid integration into the global financial system. In addition, there has been a steady

accumulation of evidence that the perceived benefits of financial market liberalization in terms of growth and stability are not supported by the data, or have not come to pass (Prasad et al, 2003, Lee and Jayadev, 2005, Gourinchas and Jeanne, 2002). As a result, there has been a significant reversal in the commitment to financial deregulation and growing concern about its effects on social outcomes.

The following chapters attempt to make an empirical contribution to the literature by adopting a two pronged methodology: a cross country analysis of a particular question raised by the theoretical literature, and two case studies of developing countries designed to make a detailed assessment of the distributional consequences of financial reforms.

The cross country study, (chapter 2) explores the effect of capital account liberalization on the functional distribution of income.In doing so it provides empirical traction for the hypothesis (cf Rodrik, 1997, Crotty and Epstein, 1996 , Harrison, 2002) that capital mobility reduces the bargaining power of labor, thereby lowering the share of national income going to the labor share of national income. In doing so, the dissertation contributes to a large body of cross country work which attempts to identify where openness has an econometrically relevant effect on other macroeconomic variables of relevance.

While internal and external deregulation often involves a similar set of deregulatory measures across countries, the specific channels and intensity with which this affects distribution in different countries varies according to a large set of conditioning social, institutional and historical factors. Chapters 3 and 4 explores more closely the relationship between internal and external financial deregulation and distributional outcomes in two developing countries, India and Indonesia. As such, the case studies follow institutionally oriented research such as (Haggard et al 1993, Keohane and Milner , 1996, Grabel, 1995, Dutt and

Rao, 2001) in identifying subtler structural or longer-term impacts of the changing political, rural-urban and state- market relationships following liberalization.

The following section outlines the dissertation and methodology employed.

1.2 Methodology

Chapter 2 uses an unbalanced cross country panel data analysis to assess the impact of capital account openness on the labor share of income. The structural equation to estimate this effect is motivated by a two sector general equilibrium wage bargaining model which accounts for structural differences between countries. Research on financial openness has been hampered in the past by the lack of a meaningful index of capital mobility which is both broadly available as a time series for a large number of countries and compelling as an indicator. Drawing from the International Monetary Fund's abundant data on capital restrictions, this chapter employs an index developed by Kang-Kook Lee and myself [1], which solves some of the extant problems with the data. The United Nations national accounts data are used to extract a common cross country measure of the labor share of national income.

Employing a fixed effects model to control for country-specific variation, the chapter tests the hypothesis that capital account openness reduces the labor share of national income. Although individual country heterogeneity is supposed to be accounted for by a fixed-effects model, the presence of such fundamental differences as a large informal sector in developing countries may make a structural equation across both developed and developing countries inappropriate and unsatisfactory. In addition, the effects of openness on labor outcomes are likely to vary by the level of development. To account for this, the estimation equa-

[1] With assistance from Mathieu Dufour.

tions are also estimated separately for the low-income, middle income and upper income groups of countries.

While financial liberalization presumably involves a similar if not identical set of deregulatory measures across countries, the specific channels and intensity with which this affects different countries varies according to a large set of conditioning social, institutional and historical factors. Cross country analyses cannot, almost by definition, take this into account, and have come into some criticism for this[2]

Accordingly, chapters 3 and 4 describe the trajectory of the financial systems of India and Indonesia in terms of their regulation and deregulation from the 1970s to date. The chapters use a 'before-after' framework to trace the effects of the liberalization programs of the 1980s and 1990s on various aspects of inequality, such as access to finance, gini based inequality, urban vs. rural development and development spending.

In doing so, these chapters situate themselves in a political economy inspired perception of the role of finance in economic development. Starting from Gerschenkron (1962) onwards, this theoretical tradition has seen external and domestic financial regulation as a central element in a successful and broad based transition to an industrial economy. Regulation is seen as a necessary measure to aid industrial policy (Crotty and Epstein, 1996),to reduce externally generated instability (Palma, 1998, Grabel, 1995) and to assist countries move up

---

[2]Pieper and Taylor, 1998 put it both succinctly and searingly:

> Lacking rich historical description, attempts at empirical analysis will be at best ambiguous and controversial due to weak methodologies and poor statistics, the overwhelming difficulties in correctly identifying the 'counter-factual', and debates about whether neoliberal policies have really been adopted. (Pieper and Taylor, 1998)

the productivity chain (Chang, 2002). The importance of financial regulation in order to maintain a reasonable income distribution in the face of transition is very much a theme of this strand of research.

The case studies employ a Marxian lens to view the question.Each of the case studies focuses on the effects of financial liberalization on three sites or 'circuits' of finance where resources are contested: the banking sector, the capital market and the government budget (through government debt and expenditure). That is, in an analogous manner to the analysis in Marx (Marx, 1967), the reproduction of the three sectors is seen as involving political processes and confrontations between individuals and groups for financial resources. Financial liberalization changes the relative power of these groups, and consequently, their shares in resources generated through these circuits. Such an analysis is explicitly modeled in chapter 3 as a wage bargaining model. In the case studies, changes in actual distributional outcomes in terms of these various groupings (urban-rural, rich-poor, large borrower-small borrower, state-bond holders etc.) are identified and described.

Complex phenomena such as inequality and poverty have multiple causes. Given this, it is very difficult to obtain proper identification mechanisms through which to make causal statements linking financial deregulation (or any other policy) to such outcomes. As a result, the case studies utilize a framework in which plausible linkages are elaborated upon by a combination of descriptive statistics and short time series econometrics. Chapter 3 deals with India from the nationalization of banks through the period of (as of yet incomplete) financial liberalization. Chapter 4 deals with Indonesia from the establishment of the New Order government in 1967 through the financial liberalization and crisis of the 1990s to date.

The concluding chapter (chapter 5) summarizes the findings of the dissertation. It discusses the policy implications of the analysis undertaken and considers further avenues for research.

CHAPTER 2

CAPITAL ACCOUNT OPENNESS AND THE LABOR SHARE OF INCOME

2.1 Introduction

> The world has changed. More intense competition, both within and between countries has decreased rents. Financial capital moves around, physical capital relocates. The old view just no longer applies, and the limits of redistribution through the market are much tighter. Trying to appropriate the rents may lead firms to move to emerging markets, or else just go bankrupt
>
> Olivier Blanchard, Libération, December 2002

A significant issue within the political economy of globalization concerns the distributional consequences of the increased mobility of capital vis *à* vis labor. In the last few years, a common story has developed about this process. A brief précis of this narrative, found both in the popular press(as in Blanchard, above) and in academic accounts (Rodrik 1997; Crotty and Epstein, 1996) runs somewhat as follows. In an environment of increased global competition and capital mobility, rents and quasi rents in production are significantly squeezed. However, in such a world, capital's share of these reduced rents is decisively *increased*, since capital now can seek higher returns from abroad more easily than before, thus enhancing its position in a strategic bargain with labor.

Despite the seeming ubiquity of this narrative, there have been few attempts to test the effects of openness to capital flows on the share of income going to

labor at the economy-wide level[1]. Much attention has been focused on the effects of trade integration on wage outcomes, but by contrast, relatively little attention has been paid to assessing capital market integration. Some theoretical studies have operationalized the idea of the strategic bargain in a Nash bargaining framework (Rodrik, 1997; Zhao, 1998; Bughin and Vannini, 1995; Choi, 2002, Mezetti and Dinopoulos, 1991), and there have been some empirically oriented microeconomic studies focused on the issue in the context of U.S unions (Gaston and Trefler, 1995; Slaughter, 2000 ; Choi, 2002) The implications for macro level outcomes, however, remain unstudied. Yet, at the same time, macroeconomists have documented large reductions[2] in the labor share of national income in a few countries over the last two decades (Poterba, 1999, Blanchard 2000) the era– perhaps not coincidentally,–of major increases in capital mobility. This is an important connection since many of the accounts of globalization (for example, Blanchard's statement above) appear to center on the impacts of capital mobility on the bargaining power of labor as a *whole*, and hence on macroeconomic outcomes. An obvious question suggests itself. Does the hypothesis that capital account openness reduces the share of income going to labor have any empirical traction at the macroeconomic level?

A related question regards how generalizable such a claim is.The bargaining argument makes no evident distinction *per se* between high and low income economies. There are, however, numerous obvious differences between countries in this context. Richer countries possess a constellation of social structures, regulations and institutional frameworks which make a bargaining theoretical argument seem plausible. Even in the absence of a large proportion of formal

[1]Harrison,2002 remains the sole exception.

[2]In some cases as much as 10 percent of gross domestic income.

unions, the organized sector is large, and tacit agreements and political accords between capital and labor as a whole often prevail. By contrast, middle and low income countries possess significantly different labor market conditions. In countries with per capita income even as high as 2,000 dollars to 5,000 dollars, social security and unemployment benefits are insignificant. Employment in the unorganized sector is large: current estimates suggest that informal employment comprises about one-half to three-quarters of non-agricultural employment in developing countries (ILO 2002a, ILO 2002b)). Employment in this sector, characterized by lower wages and uncertain legal protections and mandated benefits, is the typical domestic fall back position of the majority of employees in the organized sector. Nevertheless, it is a priori possible that the bargaining effect of openness may still hold some relevance for organized labor even in lower income economies, especially if labor in this sector is somehow differentiated from other labor.

This chapter explores these questions using panel data from the United Nations National Accounts Statistics Database for over a hundred countries for the period 1972-1995. A significant advance in this chapter is the use of a new and more nuanced index of capital account mobility developed by Lee and Jayadev , 2003. This index follows Quinn , 1997 in developing an original measure of openness which codes for the intensity of capital controls. Details on its construction are given in the section on data and in the appendix.

The analysis presents a central result: controlling for various contemporaneous factors,capital mobility has a direct negative impact on the labor share of income in all samples and sub-samples, except for the low-income country sample[3]. This finding provides support for the argument that openness reduces the

[3]See appendix 2 for a list of countries by income level.

bargaining position of labor and the share of income going to labor, but suggests that this effect is concentrated in more developed economies.

The remainder of this chapter is structured as follows. In the first section, I present a simple two sector model of an economy which is opening up its capital account. The model formalizes the effects of capital mobility on intra firm bargaining over rents in an oligopolistic setting, and on the labor share of income within the representative firm and the organized sector as a whole.I then discuss the potential effect on the economy wide labor share. The next section concerns the data used in this chapter.I briefly consider the literature on these effects before turning to the analysis of the data.The final section provides a summary of the results as well as an evaluation of the findings.

2.2 A Wage Bargaining Model

Consider an economy in which production takes place in an organized sector and an unorganized sector. In the former sector, labor market outcomes are the result of a bargaining game between capital and labor represented by a monopoly union. Output is produced according to a Leontief production function with fixed coefficients technology[4]. In the unorganized sector, there is little or no capital and/or individuals are self employed. This can be operationalized as a competitive sector in which the entire return in production is wage income. Both sectors produce using a variable amount of labor. As such, firms produce according to a following simple production functions:

$$Q_u = L_u \tag{2.1}$$

[4]The qualitative conclusions of the model will not change even with a variable coefficients technology, as long as the elasticity of factor substitution is less than one.

for the unorganized sector, and

$$Q_i = min[\gamma L_i, \theta K_i] \tag{2.2}$$

for any firm in the organized sector

Beginning with the unorganized sector consisting of identical firms, it is assumed that the productivity of labor is given and fixed at w_u. The competitive sector can be assumed to display the following form in equilibrium:

$$w_u = p_u \tag{2.3}$$

And thus, labor share in the sector is $\frac{w_u L_u}{p_u Q_u} = 1$.

The organized sector consists of n identical firms in a Cournot game which are all producing a homogenous good. The output of the firms are given by $(L_1, L_2, L_3 ... L_n)$. The output of the sector is given by

$$Q_o = \sum_{i=1}^{n} Q_i = \sum_{i=1}^{n} \gamma L_i \tag{2.4}$$

with

$$L_i = \frac{L_o}{\gamma n} \tag{2.5}$$

where i is the ith firm

In order to close the model, a full employment condition is assumed.

$$N = L_o + L_u \tag{2.6}$$

Consider now the problem of bargaining over wage and employment between the labor union and the representative firm. The union cares about wages, and thus the objective function of the union is of the form:

$$u = u(w_o; w_u) \tag{2.7}$$

where w_0 is the negotiated wage and w_u is the fallback wage with $w_o \geq w_u$(in this case the competitive wage available in the other sector).

From the production function, the profit of the ith firm is given by:

$$\pi_i = g^{-1}[Q_o]Q_i - w_o L_i - r_o K_i = g^{-1}[Q_o]\gamma L_i - w_o L_i - r_o K_i \tag{2.8}$$

where $g^{-1}[Q_o]$ is the inverse market demand function.

In the event of a breakdown in negotiations, the firm is assumed to be able to obtain a return from abroad on capital equal to ρ, and that the perceived return from abroad is at least equal to the return in the home economy.

The return from abroad, however, is reduced by the presence of capital controls in the home country. Capital mobility (or equivalently, freedom to move production to another location abroad) can be parameterized simply by ϕ where $\phi\epsilon[0, 1]$ and thus the fall back position of the firm is $\phi\rho$. Thus the threat point, or return on capital abroad of the firm, is given as

$$\tau = \phi\rho \tag{2.9}$$

I assume that workers do not see themselves as capable of attracting a new firm to the economy. As such, there is an asymmetry in fall back positions. Assuming that the exogenously given bargaining power of the union is α (and thus the corresponding power of the firm is $(1 - \alpha)$), α ϵ[0,1], the generalized Nash bargain is as follows:

$$Max \quad \Lambda = [\pi_i - \tau]^{1-\alpha}[u(w_o; w_u)]^{\alpha} \tag{2.10}$$

with respect to w_o

Taking logs this can be rewritten as:

$$Max\ log(\Lambda) = (1-\alpha)log(\pi_i(w_o) - \tau] + log(\alpha)[u(w_o; w_u)] \tag{2.11}$$

with respect to w_o

Maximizing this function with respect to the wage:

$$\frac{\alpha u'}{u(.)} + \frac{(1-\alpha)(\pi_i')}{\pi_i - \tau} = 0 \tag{2.12}$$

This can be written in implicit terms as

$$Z(w_o, \tau) = 0 \tag{2.13}$$

Totally differentiating the function yields:

$$Z_\tau d\tau + Z_{w_o} dw_o = 0 \tag{2.14}$$

and

$$\frac{dw_o}{d\tau} = \frac{-Z_\tau}{Z_{w_o}} \tag{2.15}$$

From the total differentiation of (14) and the first and second order conditions, it can be shown that:

$$Z_\tau > 0, Z_{w_o} < 0, \frac{dw_o}{d\tau} < 0 \tag{2.16}$$

In other words, with a rise in the fallback option of capital in this sector, the bargaining power of labor is reduced, leading to a decrease in the wage rate in the sector.

2.2.1 Labor Share Under Increasing Openness

The wage share in each firm is given by

$$\beta = \frac{(w_o L_i)}{g^{-1}[Q_o]Q_i} = \frac{(w_o L_i)}{g^{-1}[Q_o](\gamma L_i)} = \frac{w_o}{g^{-1}[Q_o]\gamma} \tag{2.17}$$

since w_o falls with increasing τ from (16) above and $g^{-1}[Q_o]\gamma$ remains unchanged, the wage share in each firm and thus in the sector as a whole falls as a result of increased openness.

The labor share in the entire economy by definition is:

$$\Omega = m(LS_o) + (1-m)(LS_u) \tag{2.18}$$

where LS_o is the labor share in the organized sector and LS_u is the labor share in the unorganized sector and m refers to the weight of production of the organized sector in the economy.

This can be rewritten as

$$\Omega = m(\beta) + (1-m)(1) \tag{2.19}$$

since $LS_o = \beta$, $LS_u = 1$. From this, it is easy to see that

$$\Delta\Omega = m(\Delta\beta) + (\beta - 1)(\Delta m) < 0 \tag{2.20}$$

The first term above refers to the partial effect of the threat of relocation abroad which reduces the labor share in the formal sector (a threat effect). The latter term refers to an inter-sectoral effect, in which labor moves from the sector with higher labor share to lower labor share (a composition effect) as Δm rises. In developed countries -where m is close to 1- the negative effect from increased capital mobility on labor share is restricted primarily to the rent squeeze effect imposed on labor in the organized sector. In developing countries -

where m is significantly lower than 1- any substantial decrease in the labor share in the overall economy is more likely to arise from a composition effect, whereby an increase in capital formation in the organized sector expands production in that sector and draws labor in from the unorganized sector. This, in turn, will occur only if there is an increase in the capital stock following capital account openness). If, by contrast, there is a capital outflow out of the organized sector to the outside world(a possibility that cannot be discounted)[5], Δm will be negative and the effect on the labor share will be ambiguous. As such, the model predicts direct negative effects of openness on the labor share in developed countries and indeterminate effects in poorer countries.

The purpose of the model was to isolate and assess the effects of openness on the bargaining process between firms and workers and the resultant effects on the labor share of income. As such it does not consider other important (and correlated) real life events such as trade liberalization, labor market reform, the drawing back of the state and deregulation, all of which will may have strong effects on the bargaining process. I consider these in the empirical section.

2.3 Data and Trends

2.3.1 Measuring Financial Openness

Most efforts to identify the presence of capital account restrictions have relied primarily on the annual publication of the IMF "Exchange Arrangements and Exchange Restrictions" which provides details on various regulations on capital account transactions across countries. It has represented the central source for various constructions of financial openness (Quinn, 1997, Kraay 1998, Klein and Olivei, 1999, Edwards, 2001,Chinn and Ito , 2003). Studies have constantly faced

[5]See Morissey and Baker, 2003. for evidence of this.

the problem of assessing the degree and intensity of restrictions to the mobility of capital. This is an important problem, since many countries, even those that are relatively developed, have maintained a variety of capital controls with varying intensities, which presumably have different impacts on the variables of interest. Researchers have come up with various responses, ranging from an outright ignoring of the problem (i.e. treating it as a binary indicator) to providing various remedial measures[6]. Quinn' s index remains the definitive study in this regard. Quinn codes the intensity of controls in balance of payments using data on statutory restrictions. However, these data are only available for non-OECD countries for 4 years. Lee and Jayadev, 2003 reproduce the methodology, slightly modified, utilized by Quinn for his analysis of capital account restrictions and apply this to all the countries in the IMF annual report for the period 1972-1996. While there are substantial evaluative judgments to be made regarding the qualitative nature of the report, we find that our coding has a 0.97 correlation coefficient with Quinn's index for OECD countries and a 0.91 correlation for the two years in the period for which he provides data for all countries. The strength of these correlations, as well as checks against other data suggests that our measures are reasonable. The details of the coding methodology can be found in the appendix.

Figure 1 details the movements in capital account openness over the last two and a half decades using this indicator. Openness has increased in all groups of countries, with the early nineties being the period of rapid opening up by lower income countries.

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[6]Kraay, 1998 for example distinguishes only between major periods of change (5 years of controls followed by 5 years of no controls).

2.3.2 Measuring Labor Shares

The UN dataset is a regularly published and consistent series,based on the system of national accounts, 1968. It is estimated on the basis of surveys of enterprises or establishments and government accounts.I define the labor share of national income as the ratio of compensation of employees to GDP[7] from the table of cost components of GDP. Compensation as defined includes both wages to employees, as well as other benefits such as pension payments.The variable used here corresponds to the overall measure of labor share (Ω from the model).

Ideally the data should be disaggregated by the two sectors to test the model above, but is not.While in theory, the informal sector is to be included in the data, in practice,by their very nature, enterprises from this sector may not be. As such, the overall labor share of income in developing countries is likely to be underreported and may underestimate the labor share in the overall economy (if,as we have assumed, the labor share is higher in the informal sector).

Gollin, 2002 and Krueger, 1999 flag another connected problem. They both note that the earnings of self-employed persons are not included in the series and as such, their earnings are falsely considered as accruing to capital. Gollin suggests a very simple correction to the series, by making adjustments to reported operating surplus of unincorporated enterprises, a point which I discuss further in subsequent sections.

Turning to the description of the data, Table (2.1) depicts the time trend of labor shares by country groupings divided into pre 1980 and post 1980 trends (1980 acting as the rough marker for the period of globalization and reforms). The table shows a negative time trend across all broad country groupings since 1980. In Western Europe, East Asia, North America and the MENA region,

[7]This measure of the labor share has recently been used in a few papers (Diwan, 1999, Diwan, 2001, Harrison , 2002.

labor shares have either remained stagnant or declined during the 1980s and 1990s after rising from 1960 to 1980. In Latin America and Sub-Saharan Africa, negative time trends have persisted through the entire period. The finding is in keeping with the general opinion among researchers of the developed economies (Poterba, 1997, Blanchard, 1997) that the labor share of income has fallen over the last 20 years, especially in Western Europe.

There is also substantial variation in the labor share of income in the data set across countries. Figure 2.2 provides some evidence for the first point,showing a marked difference between the relative constancy of the U.S labor share over time and the significantly different trajectories of the labor share in Japan, Nigeria and Saudi Arabia. Both the variance in the data and the negative time trend call into question the appropriateness of a Cobb-Douglas aggregate production function (with resulting fixed factor shares) which underlies many macroeconomic models.

2.3.3 Control Variables

The model provided above gives some circumstances under which to expect a decrease in the labor share of income following openness. There are, however, numerous other mechanisms which are contemporaneous or otherwise correlated with financial opening which may affect the labor share of income.

Capital account openness is correlated with the level of development, which in turn has strong effects on the labor share. In the first instance, richer countries have higher capital-labor ratios. As Poterba, 1997 has emphasized, if the production technology is such that the elasticity of substitution is less than one, higher (K/L) ratios will result in higher labor shares of income[8]. In addition to the fact that one may expect to see rising labor shares because of capital

[8]Rowthorn, 1999, provides some empirical evidence that for most OECD countries, labor and capital display an elasticity of less than one.

accumulation with development, labor shares may be rising because of what can be termed a Kravis-Kuznets process. Both Kravis (1962) and Kuznets (1966) emphasize the process of development and structural change as the major reason behind the increase in wage income to GDP ratios. Among the important structural shifts which occur with increased income are a movement of labor away from agriculture into a position of organized wage labor, demographic changes and urbanization (which increase the average age of retirement and women's participation in the paid labor force) and the development of organized labor. In the expectation that labor shares rise with the level of development, I use the variable log(gdp per capita) as a proxy, obtained from the Penn World Tables 6.1.

Numerous other deregulatory processes may occur at the same time as financial opening. Perhaps for the purposes of this analysis the most crucial concurrent process is trade liberalization. Theoretically, from the Heckscher-Ohlin model, labor shares will rise in developing (labor abundant) countries and fall in developed(capital abundant) countries.In recent papers, using similar data to my own, Ortega and Rodriguez, 2001 and Harrison, 2002 suggest that this symmetry does not hold, and that there is a negative correlation between trade openness and the labor share of income across all country groupings. They take this to be evidence that trade openness has a negative effect on the bargaining power of labor. Reddy and Dube, 2001 provide a general equilibrium theoretical model which predicts the same effect. Both Ortega and Rodriguez, 2001 and Harrison, 2002 however, use primarily the ratio of actual trade to gdp as a measure of openness. The measure has been criticized on two fronts: first, as confusing ex ante and ex post openness, and second as being intrinsically correlated with the income and size of the country (see Rao 1998b). While there

are numerous other indicators of openness in the literature[9], I use two measures which best capture the intensity of restrictions to trade. The first is the ratio of trade taxes to trade from the world development indicators, and is thus a *de jure* measure of restrictions on trade. The second defines openness as the residual when the trade ratio of a country is regressed on the log of per capita gdp and the log of population(see Rao, 1998b). The logic of this measure is to obtain an indicator of trade integratedness, after purging the indicator of the correlations between trade ratio and economic size. Figures 3 and 4 present the evolution of openness across time by country groupings. Using the trade taxes to trade measure, both middle and low income countries have seen a steep decline in restrictions to trade while high income countries have reduced restrictions from already very low levels. Using the trade openness residual measure, all country groupings have seen increasing openness, starting from different initial conditions with richer countries being more open to trade at the outset.

Diwan, 2001 documents very large reductions in labor share following financial crises.[10]. Given that many economists have confirmed that macroeconomic volatility increases with increasing international capital mobility, this is an important channel by which openness affects the labor share of income[11].In this

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[9]Yanikkaya, 2003, lists over twenty indicators of trade openness that have been used.

[10]As he puts it: *labor is not simply a bystander that is hurt unintentionally by financial crises, but rather, .. temporary changes in distribution can be a means by which labor partially bails out capital, and thus plays an important role in resolving financial crises.*

[11]Kaminsky and Reinhart , 2000 have found that capital account liberalization immediately preceded macroeconomic crisis in 18 of 22 cases they study.Another regionally focused cross-country study by Gavin and Hausmann, 1996 further bolsters the argument by arguing that openness and lending booms have almost always preceded banking crises in Latin America. Finally, Gourinchas, Valdes and Landerretche , 2001 verify this finding for a different sample of countries.

study following Frankel and Rose, 1995, I define a crisis as occurring when the external value of the currency falls by more than twenty percent in a year.

Capital account liberalization is claimed to constrain government spending (Garrett, 2000, Rao, 1998a,Garrett and Mitchell, 2000). Under this argument, openness is said to subject governments to market discipline, and thus reduce its role in the economy. Harrison (2002 finds that labor shares are partly driven by changes in government spending and government intervention in the economy in general. Thus, to the extent that government expenditure in the economy is constrained by openness, one would expect to see a fall in the labor share of income. Two measures are used to account for the governments involvement in the economy. First, the government share of GDP (from the Penn World Tables 6.1) is used to proxy for the importance of the government in the structure of the economy and second, the budget deficit as a percentage of GDP (from the world development indicators) as a measure of short term spending.

Finally, a control needs to be put in for the interest rate. Following liberalization of capital flows, the ability and willingness of governments to repress interest rates is weakened, as capital can gain higher returns elsewhere. The effects of this on the labor share of income are ambiguous. From a purely neoclassical viewpoint, the ultimate effect on the labor share again depends on the elasticity of substitution (σ) between labor and capital on the aggregate production function level. If $\sigma < 1$,labor shares rise in response to higher real interest rates. Data on the real interest rate is obtained from the Global Development Finance CD and World Development Indicators. Missing data are filled in from Easterly, Rodriguez, and Schmidt-Hebbel (Statistical appendix), 1994.
Table (2.2) summarizes these indicators in the pre and post globalization periods. In order to test these hypotheses, a panel data estimation with the following simple OLS specification is undertaken

$$LS_{it} = \alpha_0 + \alpha_i + \alpha_1 CAL_{it} + \sum_{j=1}^{J} \beta_j x_{jit} + \varepsilon_{it}$$

where LS is the economy wide labor share,the variable CAL is the indicator of capital account openness and the vector x_j refers to a set of macroeconomic and structural controls.

2.4 Estimation Results

Table (2.3) estimates the equation above across all countries. Column (1) assesses the partial effect of capital account openness on the labor share of income controlling for trends and for the level of development for the largest possible sample. In column (2), I introduce trade liberalization (as measured by the ratio of trade taxes to trade), a dummy for crisis, and the real interest rate. In column(3), I provide the full specification, introducing the government share of GDP and the budget deficit. In column (4), I replace the measure of trade liberalization with the measure of trade openness as a residual. Finally, in column (5) I repeat the estimation from column (1) with the final sample as generated by the full specification in order to demonstrate that the central result is not very sensitive to the sample selection. Given the paucity of data for some indicators,adding more independent variables leads to significant reductions in the sample size. As such, the number of degrees of freedom falls and standard errors become quite large, leading to insignificant coefficients. This being said, there are a number of striking results that can be seen.

Columns(1)-(5) present the central result. Capital account openness exerts a significant, direct and negative effect on the labor share of income in all specifications. Increasing the capital account openness index by one unit results in a decline of around 1% in the labor share of income, depending on the specifi-

cation[12] This central result differs from the finding of Harrison, 2002, for whom capital controls only matter when interacted with general government intervention.

Table(2.3) also shows that factor endowments and accumulation, as proxied by the log of GDP per capita, have a significant positive effect on the labor share of income in most specifications. The variable accounts for a large part of the variance in the sample suggesting that accumulation is a very important variable in determining the labor share of income.

Introducing the two trade openness variables provides some interesting results. Using the trade taxes to trade indicator it would appear that trade liberalization increases the labor share of income by 0.2% on average. By contrast, using the trade openness residualized measure, there is a directly opposing result: trade openness *decreases* the labor share of income. This apparent contradiction occurs because each measure weights different subsamples differently. As is evident from figure 3, trade taxes as a percentage of trade have been small in high income countries throughout the period in question. As a result, the measure weights the countries which have seen the most significant reversals of labor shares in the post globalization period the least. The trade openness as a residual measure, by contrast, suggests that the high income economies are the ones which have seen the most trade integration in the last two decades (as can be seen in figure 4)and weights these countries more strongly. In column (4), replacing the trade taxes measure by the residual measure reduces the impact of the capital account openness variable on the labor share of income by about half, and reduces the value of the t-statistics as well (although capital account

[12]Harrison, 2002, using a dummy measure of openness, also finds a similar impact.In her estimation, capital controls raise the labor share of income by about 1-2% .

openness still remains significant). This suggests a strong positive correlation between trade integration and capital account openness. In fact, it is possibly the central reason why Harrison, 2002 finds weak effects for capital controls.

Crises enter the model with a negative sign in most instances, but they do not change the coefficient of capital account openness considerably. In the event of the crisis, the labor share of income drops by about .5% depending on the specification. This result confirms the finding from Diwan, 2001.

Real interest rates have small but highly significant effects on the labor share of income (a one percent increase in the real interest rate increases the labor share of income by 0.06%).

Finally, a larger government presence, whether measured by the government share of GDP or by the budget deficit, affects labor share positively and significantly. However, these effects are small.A one percent increase in the government share of GDP results in a 0.01% increase in the labor share of income. The effect of the budget deficit is similar in size.

From the model presented, the threat of capital mobility should adversely affect the labor share of income most strongly in relatively high income countries which possess larger formal sectors, institutionalized bargaining structures and higher wages.In developing countries with larger unorganized sectors, the magnitude of rents being squeezed because of direct bargaining effects will be smaller, given the weak bargaining position that labor has initially. The composition effect is critically contingent upon capital inflows into the formal sector- a condition that may or may not be fulfilled. As such, one should expect the labor share to respond more strongly to capital account openness in high income countries than low income countries and in more unionized economies than less unionized economies. Table (2.4) tests this idea. Controlling for trend and endowments, I regress the labor share of income on capital account openness by

quintile of gdp per capita and by quintile of union density[13]. The table shows evidence of increasingly strong and significant negative correlations between capital openness and labor share as one moves from poorer to richer economies and from less unionized to more unionized countries, a finding that supports the bargaining argument.

In table (2.5) I repeat the full specification in table (2.3) dividing the sample into high income, middle income and low income countries.As the number of observations drop, the standard errors rise and some variables become insignificant. Nevertheless, in both high and middle-income countries as a whole, capital account openness is associated with statistically significant losses for labor in the presence of all the controls. Interestingly, the effect is stronger in middle income countries on average than in high income countries. For low-income countries, capital account openness appears to play no role in determining labor share, entering with a positive but insignificant sign.As suggested by the model,the effect of capital account openness on the labor share in poorer countries is ambiguous.The effect of openness on the labor share depends strongly on an increase in the formal share of employment following openness. Much empirical evidence points, by contrast, to an opposite movement. In the last two decades, the poorer economies have seen an expansion in the unorganized sector relative to the organized sector.(Beneria, 2001, Charmes, 2000; Castells and Portes, 1989; Heintz and Pollin, 2003).Morrissey and Baker 2003 suggest that in general, capital has been flowing out of developing countries rather than in over the last twenty years.This in conjunction with other processes such as privatization and the scaling back of state expenditures, may serve to increased informalization in poorer countries, and thus, have ambiguous effects on the labor share.

[13]Forteza and Rama, 2000 provides data in five year averages.

An important conclusion may be drawn from tables (2.4) and (2.5): the negative impact of capital account openness on the labor share of income increases with the level of income of the country. Also the evidence in Table (V) provides, at best, weak support for Heckscher-Ohlin effects: labor share increases significantly with more trade openness in low income countries (using the trade taxes to trade ratio measure) and decreases in high income countries (using the trade ratio residual measure).

Table (2.6) considers various other specifications and extensions of the base model. In addition to capital and trade liberalization there have been major changes in labor markets over the last two decades. Factors such as unemployment, union coverage and labor productivity are clearly important to understanding outcomes for the share of income going to labor versus capital. Unfortunately, obtaining consistent and comparable annual time series data on labor market conditions across countries, and especially for lower and middle income countries, is extremely difficult. One way to address this is by looking at the partial effect of capital account openness on the labor share controlling for some of these variables for the OECD countries where these data are available and comparable.

In column (1) of table(2.6) I repeat the base specification but add variables for trade union membership (data from the OECD statistical database), for the unemployment rate (from the world development indicators) and for labor productivity (defined as the growth of real gdp per worker from the Penn World Tables 6.1). A 1% rise in the level of unemployment is associated with a 0.3% decline in the labor share of income.A 1% rise in the level of trade union membership is associated with a 0.1% increase in the labor share of income, and a 1% rise in labor productivity results in a 0.3% decrease in the labor share of income. Although the effect of capital account openness on the labor share is

both smaller and weaker in the presence of these controls, it is still seen to exert a negative effect on the labor share.

As noted before, since the SNA classifies payments to unincorporated enterprises as accruing to operating surplus and capital, labor share as measured by national accounts is likely to be truncated, and thus is a low estimate of the 'true' labor share. Gollin , 2002 shows that divergences in labor's share are reduced if labor's share is expanded to include self-employment income. He also suggests several simple corrections by making adjustments to the national income on the reported operating surplus of unincorporated enterprises. One such correction treats the operating surplus of unincorporated enterprises as comprising the same mix of labor and capital income as the rest of the economy. If this is the case,adding the labor income component of the operating surplus of unincorporated enterprises to the compensation of employees from private incorporated enterprises and the government accounts will make the labor share closer to the true value. While the adjustment is relatively crude, it permits the use of the same data to assess the effects of including self employment.

In column (2) of table (2.6) I repeat the exercise using the Gollin adjustment.Doing this correction results in a sharp drop in the sample size (to one sixth of its original size) and now consists of only upper income countries which do report the data. Again, very strikingly, the negative effect of capital account openness on the labor share remains significant. By contrast,the coefficient on two other key variables, the real interest rate and the crisis variable, change signs. Capital account openness continues to depress the labor share of income.

How long lived is this effect? If capital account openness does reduce the labor share directly, is the effect a temporary shock, or does it change the political configuration between labor and capital more profoundly, resulting in longer lasting outcomes? In order to assess this, Column (3) of table (2.6) repeats

the exercise using 5 year averages for the period in question (1972-1996). All variables are averaged over five year intervals, and run with OLS estimations. Strikingly,the five-year averages display remarkably consistent coefficients for the effect of capital account openness on labor share, suggesting that these effects remain over at least the medium term. The coefficients for some of the controls, by contrast, become insignificant.

Establishing causality in a cross country framework is difficult, since there are few convincing instruments available. Nevertheless, as a minimal check, a final instrumental variables exercise is conducted in columns (4) and (5) of table(2.6).The specification addresses a potential problem with the estimates reported above, viz. that the independent variables and the error term are correlated and perhaps jointly determined. All variables except the trend variable are instrumented with first lags and reported both with a pure fixed effect model and a 2SLS random effects model. Strikingly, all the variables are robust to the use of IV techniques and their point values are more or less the same.

2.4.1 Robustness Issues

In addition to the estimations presented here, several other robustness checks were undertaken. Some of these may be worth mentioning. The regressions were also run using a logit transformation in order to prevent potential biases arising from regressing a bounded regressand on unbounded independent variables (see Davidson and MacKinnon, 1993). The fundamental results remained unchanged. Several other independent variables for which theoretical reasons could be constructed were tried, including trade to gdp ratios, measures of financial openness from Beck et al, 2000, the nominal exchange rate (from the IMF international financial statistics) and a measure of labor market rigidity from Rama

and Artecona, 2001 [14].In almost all specifications the central negative correlation between capital account openness and the labor share of income remained unchanged. The results also do not change when one uses another adjustment measure from Gollin, 2002[15]. I also used another proxy for the informal sector-the urban population as a fraction of total population-from the world development indicators. The results remain robust to its inclusion. A remaining question is the choice of time period. Because our capital account openness index is made for the period from 1972 to 1996,our sample is restricted to that time. However, the 1960s were a period of greater capital controls and higher labor shares, and the late 1990s have seen increasing capital account openness and diminishing labor shares. As such, the inclusion of these periods, were the data available, is most likely to strengthen rather than weaken these results.

2.5 Conclusion

Economists have paid relatively little attention at the macroeconomic level to the impacts of capital mobility on the rents going to labor. The empirical results from this chapter suggest that these effects are significant, robust, and therefore merit serious attention. Overall, capital account openness is an important correlate of the observed decline in labor shares in many countries over the last two decades. The evidence thus is consistent with the claim that capital mobility can have significant negative effects for the bargaining power of labor as a whole. However, these negative effects are not generalizable across all country groups and appear to increase with the level of income. The opening up of

[14]Forteza and Rama ,2001 use the sum of the ILO and other labor standards indicators from Rama and Artecona, 2001 as an indicator of the "thickness" of its labor code, and hence for the degree of labor rigidity as stated on paper.

[15]In essence, this adjustment assumes that all the operating surplus of private unincorporated enterprises is self employment income.

capital accounts has the strongest negative impact on the labor share in developed countries. Middle income countries as a whole also tend to see a negative correlation between labor share and capital account openness. For the poorest countries, however,the empirical analysis in this chapter did not provide evidence to suggest that the bargaining channel plays a central role in explaining falling labor shares. Structural differences between countries clearly remain important in outcomes for labor. Finally,the negative correlation between openness and the labor share of income persists through the medium term in the overall country sample.

One cautionary point is to be noted.The empirical strategy pursued in this chapter assesses the direct negative bargaining effect as a residual effect, after controlling for various processes. To be sure, as the model suggests, there are strong theoretical reasons for believing in this effect, but it is still possible that the capital account openness variable is proxying for some other (unseen and unmeasurable) institutional change in the political economy. For example, it is conceivable that having liberalized, the state is constrained to act in favor of the interests of capital.[16]If it is the case that capital openness is a signal for more profound changes in the institutional structure of the economy, this is an interesting avenue for further research.

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[16]Dunn (2000-152) for example argues the following in the case of the U.K:

> In retrospect Mrs. Thatcher's most decisive political act was the complete dismantling, at the very beginning of her first term of office as Prime Minister, of all controls over capital movements into and out of the economy. What this did was to establish a space of political competition between capital and organized labour in which, in the end, the latter could only lose, and in which it was relatively simple to present its predestined loss as unequivocally in the interest of the population at large.

In addition, there is still a paucity of research on this topic at the level of country case studies.[17] The results of a cross-country study such as this highlights broad trends, but may obscure within-country differences which may be crucial and interesting. Further research, especially for developing economies, should provide more information with which countries not yet completely liberalized can assess the manner in which capital mobility may affect their distributions of income and the welfare of their citizens.

[17]Some notable studies are Choi, 2002 and Bronfenbrenner, 2000, who more carefully assess the ways by which mobility is affecting the bargaining game between owners of capital and labor in the U.S, or Yeldan, 2002, who analyzes the changes in distributional incomes by class in Turkey.

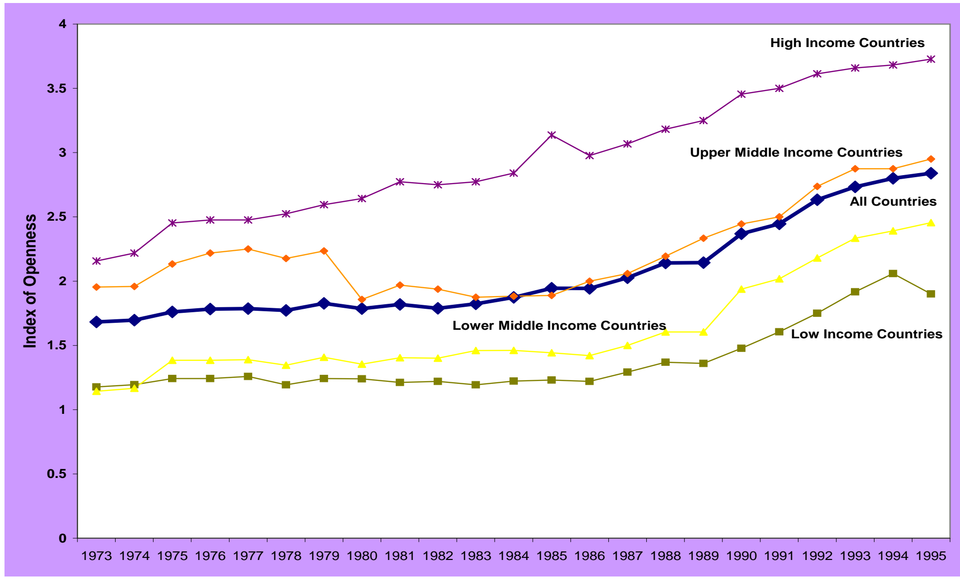

Figure 2.1. Capital Account Openness Over Time

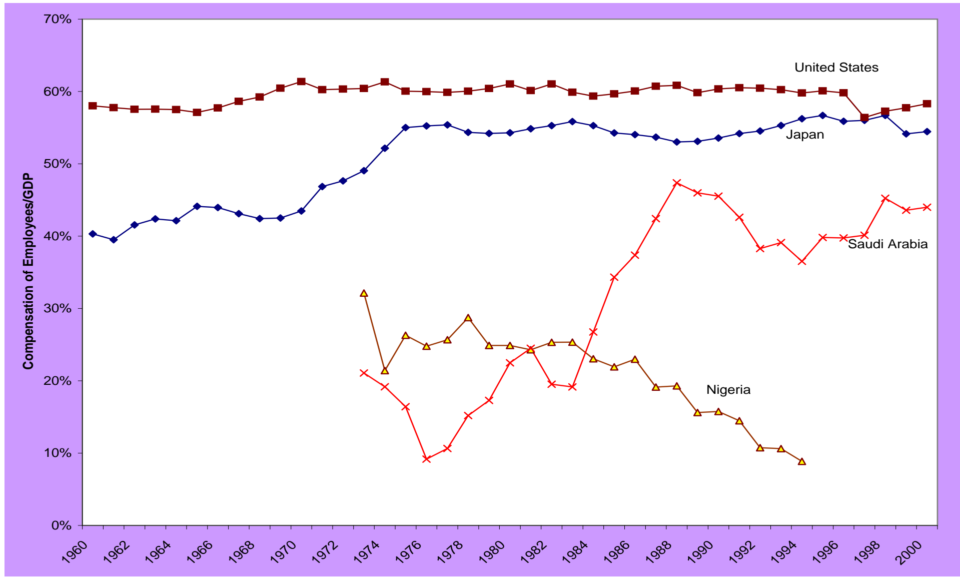

Figure 2.2. Labor Share Trends Across Countries

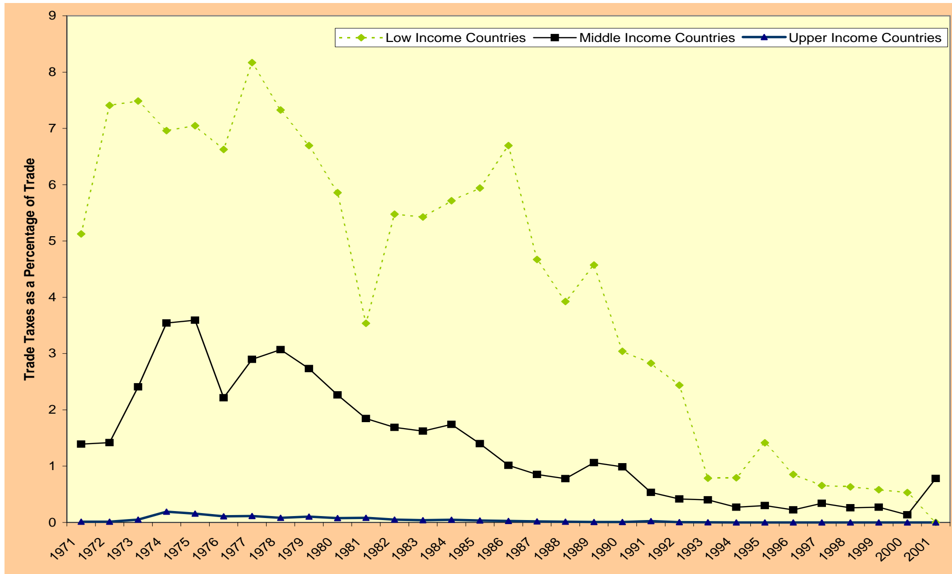

Figure 2.3. Trends in Trade Taxes as a Percentage of Trade Across Countries

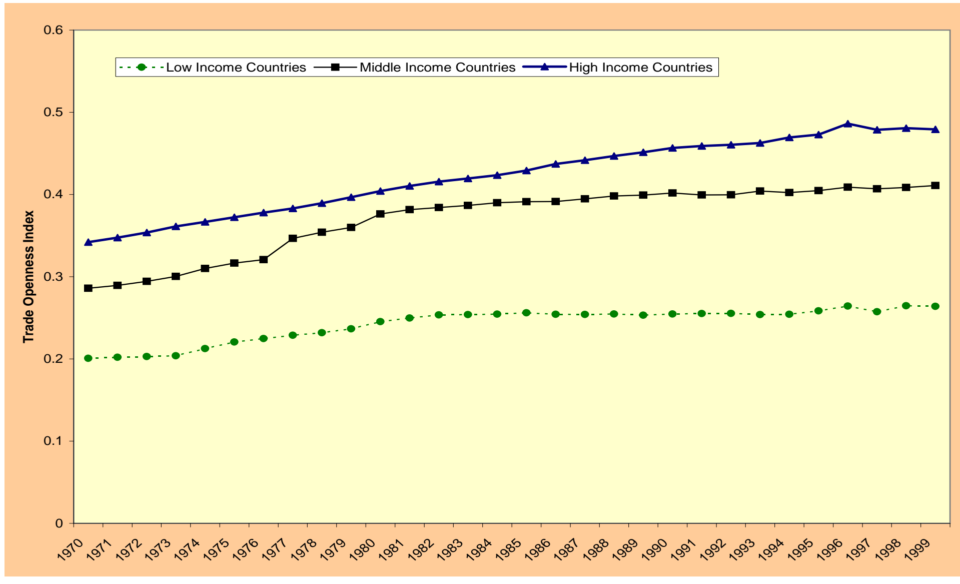

Figure 2.4. Trends in Trade Openness Across Countries

(t statistics in parentheses) (*:significant at 1%)

Table 2.1. Time Trend in Labor Shares

Income Group	Pre-1980	Post-1980	Whole Period
Low Income Countries	-.007* (5.29)	-.004* (-5.09)	-.003* (-7.2)
Middle Income Countries	.0001 (.51)	-.001* (-4.3)	-.0005* (-3.9)
High Income Countries	.003* (15.3)	-.001* (-8.32)	.0004* (4.2)
East Asia	.002* (5.6)	.0005 (1.23)	.0007* (3.7)
Middle East and North Africa	.001* (4.1)	.0002 (0.38)	.002* (8.7)
Sub Saharan Africa	-.003* (-3.13)	-.002* (-4.53)	-.002* (-7.1)
Latin America	-.001* (-3.92)	-.003* (-8.39)	-.002* (-13.51)
Western Europe	.003* (14.77)	-.002* (-11.1)	.0001 (1.14)
North America	.003* (12.15)	.001 (1.60)	.001* (6.92)

Table 2.2. Summary Statistics

	Pre 1980	Post 1980	Whole Period
Mean Labor Share*	45.4	44.1	44.7
Mean Labor Share*:High Inc. Group	51.1	49.1	50.1
Mean Labor Share*:Middle Inc. Group.	40.1	38.2	39.3
Mean Labor Share*:Low Inc. Group	38.2	36.2	37.1
Mean Log(GDP per capita)	7.33	8.65	8.08
Mean Cap. Acc. Openness	1.83	2.34	2.19
Mean Trade Taxes	2.5	.84	1.34
Mean Trade Openness	.29	.38	.34
Mean Real Int. Rate	.60	4.9	4.16
Mean Govt. Share of GDP	16.3	18.5	17.5
Mean Budget Deficit	3.84	3.12	3.30

* Sample restricted to countries with at least 3 observations before 1980.

Table 2.3. Capital Account Openness and Labor Share country fixed effects, Dependent Variable: Compensation of Employees/GDP

	(1)	(2)	(3)	(4)	(5)
Trend	-.003* (-7.4)	-.002* (-4.3)	-.001* (-2.1)	-.003* (-4.1)	-.0004 .(0006)
Log (GDP Per Capita)	.03* (5.1)	.01 (1.3)	.01** (1.69)	.17* (4.13)	-.0009 (-0.10)
Capital Account Openness	-.01* (-3.51)	-.006* (-2.17)	-.01* (-2.91)	-.005** (-1.9)	-.07* (-2.23)
Trade Taxes To Trade		-.0005 (-1.03)	-.002* (-3.56)		
Trade Openness				-2.0* (-3.76)	
Real Interest Rate		.0006* (5.8)	.0003* (3.55)	.0004* (3.89)	
Crisis		-.006* (-2.03)	-.004 (-1.56)	-.005** (-1.67)	
Government Share of GDP			.001* (4.4)	.001* (4.4)	
Budget Deficit			.002* (6.32)	.002* (6.38)	
R^2	0.39	0.20	0.11	.08	0.14
Num.of Obs	1435	894	704	724	704
Num.of Cross Secs	89	76	62	63	62

(t statistics in parentheses) (*:significant at 1%,**:significant at 10%)

Table 2.4. Quintile Groupings by Income and Union Density,Controlling for Trends and Endowments, Dependent Variable: Compensation of Employees/GDP

By Quintile of Income	1st	2nd	3rd	4th	5th
Capital Account Openness	.04 (1.01)	-.03 (-1.3)	-.016* (-2.14)	-.018* (-3.4)	-.018* (-6.09)
Num.of Obs	77	155	245	393	565
Num.of Cross Secs	16	27	36	51	40
By Quintile of Union Density	1st	2nd	3rd	4th	5th
Capital Account Openness	.02** (1.91)	.003 (0.54)	.001 (0.22)	-.006 (-1.6)	-.013* (-2.4)
Num.of Obs	136	259	195	242	226
Num.of Cross Secs	18	32	28	26	15

(t statistics in parentheses) (*:significant at 1%,**:significant at 10%)

Table 2.5. Base Specification with Country Groupings, Dependent Variable: Compensation of Employees/GDP

	High	Middle	Low	High	Middle	Low
Trend	-.001 (-1.07)	-.0004 (-0.38)	-.004* (-2.8)	-.001 (-1.06)	.002 (.2)	-.019 (-1.82)
Log (GDP Per Capita)	-.02** (1.7)	.05 (3.6)	.0006 (0.02)	.30* (5.14)	-.07 (-0.76)	.76 (1.45)
Capital Account Openness	-.01* (-4.13)	-.017* (-3.01)	.04 (.97)	-.008* (-2.99)	-.012* (-2.26)	.071 (1.58)
Ratio of Trade Taxes To Trade	.005 (.88)	-.0001 (-0.17)	-.002* (-2.11)			
Trade Openness (Residual Method)				-4.5* (-5.70)	1.7 (1.34)	-10.1 (-1.45)
Real Interest Rate	-.0005 (-0.29)	.0004* (3.28)	.001* (3.08)	-.004 (-0.85)	.0005 (3.5)	001* (2.95)
Crisis	-.006 (.16)	-.006 (-1.23)	-.001 -0.15	.003 (0.83)	-.004 (-0.85)	-.005 -0.50
Government Share of GDP	.0003 (1.00)	-.0004 (-0.48)	.0045 (5.50)	.0001 (0.69)	.0005 (3.53)	.004 (5.6)
Budget Deficit	.002* (6.5)	.003* (5.1)	-.0002 (-0.35)	.002 (6.7)*	.003 (4.90)	-.003 (-0.41)
R^2	.11	.15	.06	.06	.06	.19
Num.of Obs	385	241	78	393	252	79
Num.of Cross Secs	21	28	13	22	28	13

(t statistics in parentheses) (*:significant at 1%,**:significant at 10%)

Table 2.6. Extensions to Base Specifications

	(1)	(2)	(3)	(4)	(5)
Trend	-.004* (-6.2)	-.005* (5.2)	-.003 (-0.65)	-.002* (-3.16)	-.003* (-7.9)
Log (GDP Per Capita)	09* (7.5)	.05* (-4.52)	.006 (.43)	.04* (3.4)	.07* (8.7)
Capital Account Openness	-.004** (-1.8)	-.01* (-3.3)	-.01** (-1.75)	-.01* (-2.61)	-.009** (-1.92)
Trade Taxes To Trade	.003 (.29)	.00001 (0.0)	-.001 (-1.5)	-.002* (-2.35)	-.002* (-2.31)
Real Interest Rate	-.0001 (-.25)	-.0003 (2.25)	.0001 (.15)	.0004 (1.5)	.0003 (1.3)
Crisis	.001 (.51)	.01* (3.8)	-.02 (-1.50)	-.04* (-3.00)	-.04* (-3.00)
Government Share of GDP	.0008* (3.51)	.00004 (0.12)	.001 (.54)	.002* (4.2)	.002* (4.39)
Budget Deficit	.002* (8.4)	.002* (4.55)	.002* (2.78)	.001* (2.28)	.001* (3.39)
Unemployment	-.31 (-5.7)				
Trade Union Membership	.12* (6.01)				
Labor Productivity	-.31* (-9.4)				
R^2	0.24	0.53	0.02	.36	.47
Num.of Obs	289	338	195	638	638
Num.of Cross Secs	20	21	64	61	61

(t statistics in parentheses) (*:significant at 1%,**:significant at 10%)

(I)Sample restricted to OECD countries (II)Dependent Variable:(Compensation of Employees+ Labor Income Component of Operating Surplus of Unincorporated Enterprises)/GDP (III)Five year Averages (IV) Instrumental Variables, one lag, fixed effects (V) Instrumental Variables, 2SLS, random effects

CHAPTER 3

TRACING SOME OF THE DISTRIBUTIONAL CONSEQUENCES OF FINANCIAL REFORMS IN INDIA

> This is the way that autumn came to the trees:
> it stripped them down to the skin,
> left their ebony bodies naked.
> It shook out their hearts, the yellow leaves,
> scattered them over the ground.
> Anyone could trample them out of shape
> undisturbed by a single moan of protest
>
> – Faiz Ahmed Faiz (When Autumn Came)

3.1 Introduction

In March 1991, following a severe crisis emanating from the international sector, the Indian government embarked on a series of reforms meant to turn the Indian economy away from a dirigiste regime towards a more liberalized and globalized system. Over the last fourteen years, successive governments and further liberalization has brought wide ranging changes to all aspects of the economy, including the deregulation of industrial licensing, the dismantling of several areas originally reserved for the public sector, the overhauling of the tax system, the reduction of import tariffs and internal and external financial liberalization.

As might be expected, much has been written about the consequences of reforms, most often with respect to their purely economic outcomes (such as growth and stability) but also with regard to social outcomes such as unemploy-

ment, poverty and inequality (see Dutt and Rao, 2001 for a brief review of the major studies). Notwithstanding this large and burgeoning literature, at least one prominent gap remains stubbornly understudied. Despite seemingly numerous indications of its relevance for policy makers, there have been few efforts to address the distributional consequences of financial liberalization in the Indian economy as a whole.

This main emphasis of this chapter is aimed therefore at throwing some light on the specific nature of both internal and external financial deregulation in India, and its implications for distribution in the last decade and a half. To do this, I focus primarily on three linked but conceptually distinct 'circuits' of finance (as outlined in the introduction), which have been altered by the process of liberalization: the bank based financial circuit, the market based (or capital market based) circuit and the government finance circuit. For the most part, the descriptive analysis is confined to looking at trends before and after the onset of reforms. The 'before/after' methodology is not without problems, specifically because of endogenous and otherwise contemporaneous factors which occur with the changes in question. In order to mitigate these problems of identification, causal mechanisms are considered in each analysis.

There has been mounting concern in India among policy makers and academics (Ramachandran and Swaminathan, 2005, Patnaik, 2001), on specific issues to do with financial liberalization and distributional outcomes. In particular two areas of concern have been highlighted in their previous research. First, how has financial liberalization impacted the availability of credit to the vulnerable sections of society? Second, how has financial liberalization impacted the fiscal capacity of the state and its ability to make social and development expenditures?

The chapter addresses these questions among others. In the first section, I summarize the changes in the banking system since 1991 and focus on their distributional consequences. Analyzing Reserve Bank of India data and using a wide variety of secondary sources, the results show that there has been a significant decrease in credit availability to a large swathe of the Indian public as banks have abandoned their role as agents of development.The following section considers the effects of the scaling back of financial regulations on government revenue and development expenditure. Financial liberalization has been associated with an increased interest burden for the state in the aftermath of a costly run-up in real interest rates in the mid 1990s. A minimal econometric exercise suggests that this has had some effect in reducing development spending. The third section goes on to briefly assess the impacts of financial liberalization in the light of the liberalization-neostructuralist debate (McKinnon, 1973, Shaw, 1973, Taylor, 1983, Rao, 1995).The next section focuses on the changes in the capital market. Listing the domestic and international changes in the regulatory structure post liberalization the section looks at the concentration of ownership and its distributional effects in the stock market. In the penultimate section considers some of the other distributional effects of financial deregulation: the increasing wage disparity arising from foreign direct investment and the effect on land prices of capital inflows. The last section concludes.

3.2 Banking Reforms

The evolution of the financial system in independent India can be broadly categorized into three separate periods. The first was a period of relatively unregulated finance between 1947 and 1969 (sometimes called the pre-nationalization era). This was followed by a period of increasing direct intervention between 1969 and 1991 (variously called the era of financial repression, the era of nation-

alization, or the era of 'social control'). The last and ongoing period, consists of a movement back towards a more market oriented financial system from 1991 (called the era of financial reform).For the purposes of this chapter, I will focus on the last section of the period of social control and the period of reforms in particular.

The period of social control can be said to really date from July 1969, when 14 of the largest Indian scheduled commercial banks were nationalized. This was a direct response of the central government to the perceived non-compliance of private commercial banks in meeting the priorities set out in the post independence period five-year plans (Sen and Vaidya, 1997). The takeover of banks meant that more than four-fifths of the deposits in the Indian economy had come under public control[1] and remained under control for two decades. The consequences wrought by nationalization were deep and abiding, affecting the level and flexibility of interest rates, the volume of resources mobilized, the distribution of credit and the efficiency of the banking sector alike.

Perhaps the most impressive and positive achievement of the nationalized banks was the vast mobilization of deposits achieved by setting up of branches in the rural and semi urban areas of the country in order to facilitate agrarian development. Consequently, the population per bank branch declined significantly across the country in this period from 64,000 people per branch to 15,000 people per branch by 1989 (Sen and Vaidya, 1997). As a result of this expansion, the Indian financial system was a great deal deeper than other countries of a similar level of development[2].

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[1]This was later increased to 92 % in 1980 when six more banks were nationalized.

[2]The deposits to GDP ratio in 1989 was over 50%. For purposes of comparison, the average of the Money and quasi money (M2) as % of GDP across the 46 low income countries for which there is data available for 1989 was 21% (source:

In addition to increasing access to finance for all sections of the economy, the nationalized bank system was also put under pressure, both through regulations and informal suasion to increase their lending to sectors which were designated as having priority in the planning process. Credit in the pre-nationalized period had been clearly skewed towards urban corporate industry, which doubled its share of credit in the system from 34% to 68% in between 1951 and 1968. By contrast, post 1969, there was a concerted effort to provide credit towards those sectors deemed to be crucial to alleviate poverty and to enhance employment, including agriculture, small scale industry, artisans and retail trade. These attempts to direct credit became crystallized over the period through legislation for the 'priority sector lending requirements' for banks. In the late 1970s, banks were directed to reserve 33% of their credit for these priority sectors, an amount which was later to rise to 40% of credit advanced. These priority sector lending requirements have been contentious in the fact that they deviate from standard policy recommendations[3] and despite later recommendations to do away with these, have persisted, albeit with modifications. In addition, the interest rate was administered with varying rates for preferred borrowers.

A central problem in India, as with many other developing economies has been the inability of the government to raise non-distortionary tax revenues in a systematic and efficient way (Khattry, 2002). Given the aversion that the government displayed towards external borrowing (see Nayyar, 2000) and the increasing demands made on its resources in a planned economy, the government turned to the banking sector to provide a source of cheap funds. As a

calculation from World Development Indicators) while India's at 39% was the highest among the countries.

[3]From a neoclassical perspective quantitative controls such priority sector lending requirements represent an inefficiency in adopting quantity rather than price restrictions (see, for example, Varma , 2003.)

result, nationalized banks and scheduled commercial banks were used systematically to subsidize government spending through the mechanism of the statutory liquidity ratio (SLR) and the cash reserve ratio (CRR). Over the period, the government raised the SLR as a way by which to ensure that banks held government securities (which offered low rates of interest), and thereby helping to finance the burgeoning deficit. The CRR was also raised during the period in order to ensure that there was no expansion in the monetary base with the rise in the SLR.

Both these maneuvers had serious consequences for the short and long term profitability of the banking sector. With a large proportion of their assets being in low yield government securities, in zero yield cash reserves, and in risky agricultural deposits, banks were squeezed and began to display a significantly weaker portfolio(Sen and Vaidya, 1997). This being said, their subsidized financing of the deficit through the 1980s in particular allowed for an impressive increase in the trend growth rate and in the rate of poverty reduction, especially in the 1980s. Public infrastructural spending was increased as was the credit provided to development financial institutions. The provision of agricultural credit and the increase in the mobilization of resources in the rural sector most likely were also key important contributors to this turn of events.

In 1991, a period of major macroeconomic instability precipitated by a balance of payments crisis led to the adoption of wide ranging economic reforms in India. A key element of these economic reforms was the restructuring of the financial sector towards a more market oriented approach, centrally, the refocusing of attention in banking to profit-making.

While the moribund performance of the banking sector had come under scrutiny in the 1980s, there was not much reform that was actually passed. It was only with the favorable conditions for change following the macroeconomic

crisis of 1990, that the recommendations of the Narsimham commission in 1991 were seriously entertained. This commission brought out, in November 1991, a set of policy measures which were designed to overhaul the banking system, and which included the following main points.

The commission's recommendations were essentially to move towards a more liberal regime. First, and most crucially, the committee suggested, the pre-emption of bank resources by the government needed to be reduced sharply. To this end, a progressive reduction in the SLR and the CRR over a five year period was recommended. In addition, the interest rate on government securities, previously maintained at a low level needed to be revised upwards to be brought in line with market rates. In order to borrow from the financial markets, the government was to introduce and develop the Treasury bill market. Priority sector lending needed to be curtailed, and brought down by a factor of four, from 40% of total commercial bank credit to 10%. Concessionary finance, in the form of development finance institutional credit was to be phased out.

Second, the committee proposed the reintroduction of substantive competition (Sen and Vaidya, 1997). The simplest and most direct way to do this, it suggested, was to license new private sector banks, both domestic and foreign, and to relax branch licensing restrictions on existing and new banks. However, in order for the new system to be stable, the capital base of existing and weak banks was to be strengthened by recapitalization and public equity issues. In addition, the committee and later policy makers proposed prudential norms such as capital adequacy ratios to be followed, provisioning of bad debts, and clearer classification of assets.

Third, the interest rate structure of the economy was to be 'rationalized'. That is, the interest rate for lending rates was to be gradually liberalized from

their various slabs and the regulations on the interest rate for other financial institutions was to be lifted

It is a measure of both the willingness and the capacity of reformers to push through changes in the first years after 1991 that virtually all of these proposals, bar the removal of the politically sensitive priority sector issue, were enacted into law. Table (3.1) provides a breakup of the regulatory changes that had taken place within the banking sector by 2002.

3.2.1 Distributional Consequences of Banking Sector Reforms

By most accounts, one of the most encouraging results of reforms was the restoration of the profitability of the banking sector. While there is some debate as to which sub section of the banking sector- public or private sector banks- has been most profitable (see for example D'Souza 2002), it remains the case that the threat of non-performing assets which absorbed policy makers in the early 1990s has receded[4]. This being said, there is evidence to suggest that much of this has come at the expense of those most protected in the period of social banking: the rural and urban poor. It is to this claim that I now turn.

One of the many reasons given for the reforms was in order to counter perceived urban bias arising from distorted trade prices. Critics of liberalization have suggested that urban bias of a different sort, a direct neglect[5] of agriculture and the rural sector in general has come to occur.

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[4]In the early 1990s, gross non-performing assets represented about a quarter of total advances. By 2002, the ratio had come down to about a tenth (source: Reserve Bank of India website- www.rbi.org.in)

[5]A senior public official wrote to the Economic and Political Weekly in 1999 that " That rural credit has become unfashionable is evident from the fact that the subject is accorded only residual focus in the various congregations of our bankers. The placement policy in vogue in our banks is such that exposures in rural credit or agro-financing rarely count for promotions" (Muralidhar, 1999.)

A vocal critic of this process summarizes this as follows:

> What is perhaps more disturbing is that this deterioration in the status of the rural credit system is not by default but by design. The near total neglect of rural credit by policy-makers during the period 1991-96 is largely attributable to the adverse environment created by the financial sector reforms - reforms which were patterned on the Washington or Basle models, both of which obviously had little to offer in the area of rural credit. Reforms thus crowded out rural credit from the agenda of modernization of the financial sector.
> Majumdar, 1999b

Certain indicators suggest that this indeed has been the case, with a growing disintermediation of formal finance for these sectors. Table (3.2) shows the change in the growth rate in bank branches by population group between 1980 and 1990. In a developing country with a vast hinterland, the distance to the nearest banking center can be a deterrent for obtaining formal loans. As can be clearly seen, the growth of bank branches has fallen in the rural and semi urban sectors from 1991 after seeing an increase from 1980 to 1991. In the rural sector, the absolute number of branches, in fact has declined. To the extent that geographical access to banks is an issue, this would suggest a first order disintermediation for the rural population.

More importantly, there has been a consistent reduction in the credit deposit ratios of commercial banks in these sectors. Figure 3.1 traces these trends. In the period of repression, there was a 60% credit-deposit ratio that was prescribed for the non-urban sector. In the late 1980s this target was being achieved quite consistently in the rural sector. Post reforms, however, there has been a steady decline in these ratios. In 2000 the ratio was 34% and 40% for semi urban and rural areas respectively. There may be both supply and demand factors that are responsible for this decline. First, from the demand side, there has been a significant reduction in public investment in agriculture and the rural sector(Rao, 1998). If private sector investment is complementary in the sector, one might

expect a fall in the demand for loans. However, as Majumdar 1999b has shown, despite the decline in aggregate demand, there is a significant excess private demand for credit in these sectors[6]. The supply explanation proposed, viz. that banks attitude towards restoring profitability has led to the drying up of funds appears to be better supported. In addition,the availability of high return, low risk returns in the form of government securities has obviated the need to find good projects on the part of commercial banks.Following liberalization then, the 'supply leading' role that banks displayed in the 1980s (which certainly did contribute to improved agricultural growth poverty reduction trend rates) has been clearly abandoned.

Scheduled commercial banks have become increasingly the major source of funds for agriculture and allied activities. As figure 3.2 below shows, they constitute about 45% of credit received by the sector in 2001 from about 1% in 1971. The other major sources of credit are the primary agricultural cooperatives. As the agricultural sector has become more dependent on commercial banks,it is also more vulnerable to interest rate fluctuations in the rest of the economy and the profit making imperatives of the banking sector.

In addition, Regional Rural Banks (RRBs), Development Financial Institutions (DFI's) and the National Bank of Agriculture and Rural Development (NABARD) also direct substantial formal credit towards these sectors. Unfortunately for agricultural borrowers, there have been serious problems with these conduits of finance as well. Under the reforms wrought by liberalization, regional rural banks have had to forego access to concessionary finances. This, combined with the fact of increased distress in the rural sectors, issuing from

[6]He estimates that in 1998, such excess liquidity was about Rs. 65,000 crores, or about 15 billion dollars.

liberalization in agricultural markets and a lack of public investment has meant that the health of these banks has become increasingly compromised.

One attempt to revive rural credit was the creation of the Rural Infrastructural Development Fund (RIDF) with a corpus of Rs 2,000 crore at NABARD in April 1995. This initial capitalization was increased by the United Front Government in 1996-1998 to the Rs. 8000 Crore. However, as Majumdar(1999a) points out, although the funds were earmarked, there has been very little real utilization in terms of credit disbursed. Although the reasons for this lack of utilization are not completely understood, Majumdar suggests that poor governance and a lack of interest in agrarian development on the part of the state have been crucial.

Figure 3.3 below shows the marked decline in the relative amount of funds flowing to agriculture and the small scale industrial sector. It must be remembered that these sectors still comprise the sectors with large potential for employment generation, although the informal services and manufacturing sectors have been absorbing increasing amounts of surplus labor. Though agriculture and small scale industries have fallen as percentage of GDP, there is little to suggest that their demand for credit should fall so rapidly, given, for example, the need for modernizing irrigation and other specialized inputs. Banerjee et al., 2004 show that private banks lend about 5 percentage points less to agriculture than do nationalized banks. With the expansion of private banks therefore, credit has been expanding more quickly in the non-agricultural sector.

Another area where there has been a change in financing patterns at the lower end- both in rural and urban areas- has been in small borrowal accounts (SBA's). Table (3.3) below lists the number of small borrowal accounts (or accounts which have a credit limit of less than Rs. 25,000) in the scheduled commercial banking sector from 1984 to date. As can be seen clearly, through the 1980s the percent

of all accounts which were SBA's and the share of SBA's in all credit advanced by the banking sector remained steady, but declined dramatically in the 1990s. From 20% in 1984, SBA's accounted for only 5% of credit advanced in 2001. It could be argued that with growth and inflation, there is a natural tendency for the share of SBAs (as defined) in the system to decrease. However, to make the case that this is the reason for the decline, one would have to argue that growth in the 1990s was significantly higher than in the 1980s, more weighted towards the lower ends/sectors of the income distribution, and/or that inflation was significantly higher in the 1990s. None of the above explanations square with the facts. As such, it seems evident that banks are turning to expand their portfolios with larger, more profitable accounts while discriminating against lower income borrowers.

Another axis by which to look at the distributional impacts of reforms is by assessing the credit availability by state. The table 3.4 displays the trends across India on average and in the poorest states (the BIMARU states and Orissa) on average. Credit deposit ratios have been falling steadily across the country and especially so after the reduction of directed lending requirements in the early part of the 1990s. However, the credit deposit ratio in the poorest states (accounting for more than a quarter of India's population) has fallen precipitously, especially in the late nineties. While these states have always seen a lower credit deposit ratio than the Indian average, presumably because of fewer profitable lending opportunities, there appears to have been a disproportionate decrease in credit towards those areas, with the difference in credit deposit ratios between those states and the all India average tripling over the last five years of the nineties (from 5 to 15 percentage points). Once again the pattern is clear, with the availability of formal credit to the poorer states drying up. As Shetty, 2004 argues, the pattern is repeated at the district level as well.

3.2.2 Priority Sector Lending

While there has been substantial easing of banking restrictions, the 40% requirement remains in place for priority sector lending, despite the recommendations of the Narsimham committee[7]. In addition, foreign banks are required to target about 10% of their funds towards export oriented firms. That such a substantial portion of bank funds remains targeted credit might suggest that banks are still meeting the social goals suggested by previous administrations. In fact, the major way in which priority sector lending has continued untouched has been because of the expansion in the definition of the priority sector . Moreover, this definition of what constitutes priority sector lending is not restricted anymore to those sectors which were traditionally seen as weaker[8].

Dasgupta, 2002 has collated some of these changes. In particular, the following bear mentioning. First, there has been an increase in the ceiling for short term credit advances (sometimes called crop loans) from Rs. 5,000 to Rs. 100,000 in the post reform period. While the move may appear to be increasing credit to farmers, in fact it has shifted credit from small, marginal farmers to richer farmers, since the agricultural credit target can now be reached by lending to fewer, less risky borrowers. In addition, credit for plantation crop which was extended only to small farmers originally has now been extended to all farmers. Finally, despite a change in cropping patterns towards greater non-food crops among all farmers,(cf planning commission report, 2000), small marginal farmers are more likely to have a larger proportion of food crops for subsistence purposes. As such, the reforms which extend credit to both food and non-food

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[7]See Srinivasan, 1995 for a study of the evolution of priority sector lending.

[8]By contrast, the pre reform rationale for priority sector lending was precisely in order to provide credit to the poorer sections of society. As the Krishnaswamy committee suggested “the maximum benefit should be invariably available to the weaker sections.”(Reserve Bank of India ,1981)

crops benefit the larger farms disproporionately.Another change post 1991 is the inclusion of the purchase of motor vehicles as a part of direct advances to agriculture. While the move ostensibly allows for farmers to have more control over transportation of agricultural produce, in practice, it is only useable, once again by large farmers who can diversify to non agricultural activities.

At least partly as a result of these changes financing patterns within the agricultural sector shows significant decreases in the credit advanced to small and marginal farmers post reform. Figure 3.4 below shows the difference between the share of credit advanced to farmers with land holdings of greater than 5 acres and the share of credit advanced to farmers with land holdings of less than 2.5 acres. In the decade of the 80s this difference trended downwards, from above 30% in 1981 to about 15% in 1990,suggesting that there was a great access to loans for small and marginal farmers in this era. In the post reform period, however, there has been a substantial increase in this difference, suggesting, by contrast diminishing relative access to finance for the poorest. While it is certainly possible that there have been some demand side effects (i.e. small farmers have less demand for credit), this militates against the growing evidence of agrarian distress induced by lack of credit opportunities (cf. Vakulabharanam, 2004).

It is true that a real side collapse in the agrarian economy in the 1990s has meant that risk adjusted returns from lending to the rural sector were less than the relatively high interest rates offered on public debt. Yet, to ignore the supply side is equally problematic. There is a growing consensus that in developing countries as a whole, and certainly in India, agriculture and allied activities have seen distinct underlending given expected returns (Banerjee et al, 2004, Cole 2004). In the case of India, evidence from the pre reform period shows that the non-liberal policy of forced lending contributed to a virtuous cycle

of growth. The opposing vicious cycle of low lending, low growth, low returns and further reduced lending has been a central story of the 1990s. Shetty, 2004 succinctly summarizes the supply leading role of finance in agriculture.

> The annual growth of non-farm rural employment in the 1980s (1977-88) was 4.3 per cent but it has fallen to 2 per cent per annum in the 1990s (1988-2000). The level of farm employment has stagnated in absolute terms during 1993-94 to 1999-2000 against a growth of 2.23 per cent during 1983 to 1993-94. Growth of agricultural production has suffered a serious deceleration in the 1990s [2.4 per cent per annum] as compared with the 1980s (4.5 percent). Though there were many other forces operating in the economy to give a boost to farm and non-farm output and employment growth in the 1980s, liberal availability of institutional credit undoubtedly aided the process; the converse is equally true that in the 1990s the stunted growth of farm (or rural) employment and output has been due to, amongst other factors; limited availability of bank credit.
> Shetty, 2004

A second point made by Dasgupta is the inclusion of sectors which have reasonably easy access to formal finance without additional concessionary finance. A prime example is the October 1998 directive under which loans to software industry with a credit limit upto Rs 1 crore from the banking system were treated as priority sector lending. While loans to small scale industries (industries with a turnover of less than 1 crore) were earlier justified as providing an avenue for blue collar workers, it is entirely unclear how providing easy credit to a knowledge based industry is supposed to do the same.

Finally, another major change in the priority sector lending list has been the inclusion of housing for middle income families. Housing loans through the priority sector requirements was earlier reserved exclusively for very poor families. The raising of the ceiling to Rs. 5 Lakh in 1999 means that loans have moved towards middle income households who are better credit risks, while reducing the need for extending housing loans to poorer families in order to meet the lending requirement.

Taken in sum, therefore, while the priority sector lending requirement is unchanged in the level of credit advanced, there have been profound changes in the composition of priority sector lending. ShahJahan, 1999 argues that the expansion of the coverage of priority sector lending and the increasing of the lending ceiling for crucial areas has meant that more credit is directed towards relatively more affluent sectors, leading to fewer non performing assets but very much at the expense of the most needy.

Overall, the story of finance in the age of reforms suggest a profound gap between what is fiscally prudent and profitable for banks and financial institutions in a liberal, competitive requirement and the social needs of India. Banks have become increasingly constrained or apathetic in directing credit towards areas which have traditionally been weaker. Publicly backed financial institutions have not been able to bridge the excess demand for credit, in large part due to the withdrawal of the state from the process of intermediation. and the inability of favored alternative sources of finance principally microcredit, to bridge this gap.Ramachandran and Swaminathan,2005 for example,contest the preassumed efficiency of microcredit. They write:

> The international evidence on administrative costs of NGOs shows that these costs were high (and administrative costs are, of course, the major component of total transactions costs) and relatively higher than those of commercial banks.NGOs cannot match the economies of scale of a comprehensive system of banking (in the case of India, perhaps the best network of rural banks in the less developed world). Secondly, the costs of administration of NGOs controlled micro-credit have actually risen when NGO activity is scaled up. Thirdly, repayment rates in NGO-controlled micro-credit projects are related directly to the level of administrative costs and mobilization efforts... For the state to withdraw from the field and hand over small-scale credit to NGO-controlled micro-credit organizations is, in effect, to undermine and weaken a major national asset, the widespread rural banking system.(p14-16).

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An untold number of smaller borrowers have thus been forced, in a deeply fragmented financial sector towards high cost informal financing. Some of the social consequences of this financial disintermediation, in the form of increased peasant distress (cf Vakulabharanam 2004), lower employment generation (cf Sundaram, 2004), informalization (Pais, 2002), lower rates of poverty reduction (Pande and Burgess, 2004) and lower growth (Dutt and Rao 2001) is quickly becoming more evident. Ramachandran and Swaminathan, 2005 once again, have collated detailed case studies from on the social impacts of financial liberalization in several rural areas in the last decade. Their conclusion is unequivocal.

> If financial liberalization had the effect of damaging the system of formal credit severely, our case studies show that changes in national banking policy have had a rapid, drastic and potentially disastrous effect on the debt portfolios of the income-poor. In general, as formal sector credit withdrew, the informal sector rushed in to occupy the space that it had vacated. Although it is clear that chronic indebtedness among the rural poor is a problem that cannot be solved by banking policy alone, and that the abolition of usury requires agrarian reform, a decisive change in banking policy is essential for the very survival of the working people in rural India. Ramachandran and Swaminathan, 2005(page 23)

3.3 Government Finance

How is the relationship between financial liberalization, interest rates and government expenditure relevant to questions of distribution? In developing countries, the state often remains the only agent that can represent, however imperfectly, the interests of the poor, and transfer resources to these groups. Apart from its considerable role in redistribution, there is the fact that at least in the formal sector, the state provides an enormous source of employment. As such, the process of financial liberalization given these links addressed above might involve a subtle but powerful change in national priorities. At one level the government must prioritize to maintain investor confidence, both domestic

and foreign, in its fiscal solvency by refraining from repression and letting interest rates remain high. At the same time it cannot easily maintain its commitment to other (particularly poorer and diffuse) constituencies. This is especially so because of the fact that interest payments cannot be delayed, while development expenditures can. With a rise in the interest burden there is a 'fiscal squeeze' (Rao, 1995), particularly if reforms on the real side are reducing government's tax revenues. As a result, there is a new pressure which varies from country to country, depending on such factors as the relative openness of the capital account, the exchange rate regime and the for governments to reduce government support for social sector spending and subsidies, expenditures that are crucial both to the poor and to the long term infrastructure of the economy.

If, indeed, financial openness changes the debt structure of the state and reduces its direct sources of revenue, the stream of public spending may be subject to sudden reversals, depending on perceived fiscal solvency. Moreover, much of public expenditure, especially welfare and social sector spending requires large and consistent outlays.

In the first few years following financial liberalization, as table (3.5) shows, interest rates rose steeply across all types of securities and money markets as could be expected following a period of financial repression. The resultant sharp squeeze in monetary and credit growth resulted in sluggish industrial investment and growth, and in the overall economy in general. Between 1994 and 1999 the economy grew at an annual rate of 4.5%

During this period, as can be seen in table 3.4, the fiscal deficit remained relatively stable at between 5% and 7 % over the whole period. While this level was far below the pre reform peak of 8%, the high fiscal deficit continued to be blamed by the votaries of liberalization as the fundamental reason for the high real interest rate (Khatkhate and Villneuva, 2001). An inability to

control spending and a predilection towards profligacy and vote banking was seen therefore as a central cause for industrial sloth and macroeconomic sluggishness. Critics of the reform process pointed to a reverse causality, namely that high ex ante real interest rates, itself caused by liberalization, restrictive monetary policy and increased international exposure, had led to an increased interest burden on the Fisc, which in turn prevented the deficit from falling[9].

For the most part, the experiences of the later years of the post reform period has proved the critics right[10]. With, if anything, a small increase in the fiscal deficit, interest rates have begun to fall over the last five years, due to a combination of RBI policy, international capital surges and relatively slack demand for credit. In 1999-2000, with the high real interest rate regime still continuing, enormous pressure was put on the RBI from industry to reduce rates. The bank responded by cutting bank advance rates aggressively and lowering the cash reserve ratio. Despite a deceleration of growth in bank deposits (due to a growth of competition from mutual funds), the years between 1999 and 2003 saw a large increase in liquidity from various factors. International capital inflows increased substantially all around the world with recessions occurring in the core global economy. Asia was certainly the largest recipient of these flows, and India was no exception. Reserves in India grew enormously-perhaps

[9]A charged debate on this issue was had, inter alia, in the Economic and Political Weekly between Prabhat Patnaik, on the one hand and Khatkhate and Villneuva on the other.

[10]Chakraborty , 2002 shows that with a VAR methodology, there is a uni-directional relationship between interest rates and the fiscal deficit, with the relationship running from high real interest rates to a high fiscal deficit in India in the 1990s.

even inordinately[11]- with foreign exchange reserves as a fraction of M0 rising to over 10%[12]. In addition, there was a reduction in the cash reserve ratio by two percentage points, and a further increase in liquidity from the proceeds from the Resurgent India Bond issue in 1999.

These heavy and multi pronged interventionist measures from the RBI, in a period of sluggish growth and historically low inflation rates, led to a large overhang of liquidity in the system, which was slowly absorbed into the economy as it picked up in the next two or three years. While there was a definite increase in demand for credit, this was far below the rate of growth of supply. As Patil, 2003 puts it:

> The main reason why interest rates have continually moved southward during the recent past is that there is slackness in demand for funds from almost all the sectors of the economy except the government. The flood of liquidity expansion has been such that even large government borrowings have not been able to arrest the continual decline in interest rates.

As a result of the combination of these factors, interest rates fell to a 30 year low by 2003.

It is unclear, however, what the future trajectory of the interest rates are likely to be. Higher interest rates in the U.S and elsewhere and a recent increase in the rate of inflation suggest upward pressure, while a continuing burst of foreign capital flows keeps this pressure under check. It is in this process that the long term interest burden will evolve and it is certainly possible that this reduction in the interest burden may prove to be a temporary relief.

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[11]The Economic and Political Weekly writes in 2003, "Given its current level of dynamism, it is difficult to explain the Indian economy earning/ acquiring over 25 billion dollars of foreign currency assets in a single year"(EPW, 2003a).

[12]The rather elaborate capital control measures enforced by the Indian authorities (which allows inflows rather freely but has stringent rules for outflows) no doubt kept these finances in, even in a period of relatively slow growth.

While the low interest rate era seen over the last two years has certainly reduced the interest burden on the government, it remains at a high level, mostly due to accumulated debt. Rangarajan and Srivatsava, 2005 note that the 1990s saw a relative increase in debt absorption compared to the 1980s because of the fact that the difference in growth rates and interest rates fell in the 1990s[13]. Figure 3.5 depicts the public debt burden increasing sharply in the 1990s and running at between 2 and 3 percent over the last five years of the 1990s, before reducing in 2000. While these levels do not constitute an enormous burden in terms of worldwide standards, it remains a great deal higher than the levels of less than one percent maintained throughout the 1970s. A factor in India's favor is that her insistence on acquiring long term rather than short term debt has also meant that the latter is a small part of total outstanding debt (5.3% in 2003).

Table (3.6) shows that the interest burden as a percentage of total expenditure for both the central and state governments has continued to rise through the 1980s and 1990s. As a percentage of total expenditure, interest payments have increased from 12% to 30% from 1980 to 2001.Although in the years following, the fiscal strain from interest burdens fell, the interest burden remains at 28% of all expenditures.At the same time, from the revenues side, the squeeze is evident. There has been a fall in the overall tax effort, as trade and customs duties have fallen, and the movement towards replacing these lost revenues with income and payroll taxes has been unable to make up the shortfall. Rao, 1998 defines a fiscal index as the difference between trade taxes and interest expenditures, or (Excise+Customs Duties-Interest Payments)/ GDP. The fiscal index for India shows the severe constraints that the reform process has placed on government's resources. While the high expenditure era of the 1980s began the strain the

[13]In the 1980s, 72% of the increase in debt could be written off by increase in the growth rate. In the 1980s, only 62% could be written off similarly.

government's resources, the period following liberalization in 1992 to the end of the decade saw a much sharper squeeze.

Table (3.7) and (3.8) reports the changes in expenditure patterns for both the state and central governments over the period. As can be seen, interest payments have occupied an increasing share of total expenditures, especially over the middle and latter half of the 1990s, the period of financial liberalization. By contrast, capital expenditure and expenditures on development fell as a percentage of expenditures, both because of the changed priorities under structural adjustment and because of the fiscal squeeze.

To assess the coeval effects of increased interest burdens and decreased tax collections on public expenditure the following equations may be estimated for states and the centre for the period 1972-2002. I follow the model used by Khattry , 2002 who uses the model to assess the impacts of trade liberalization. The two interaction terms are introduced in order to conduct a minimal but sufficient structural break evaluation[14].

$$DE_t = a + T_t + I_t + T_t * L + I_t * L + L \tag{3.1}$$

$$KE_t = a + T_t + I_t + T_t * L + I_t * L + L \tag{3.2}$$

Where DE= Social Expenditures/GDP, KE= Capital Outlays/GDP, T is Tax Revenue/GDP, I= Interest Payments by GDP and L is a Liberalization Dummy (1 for the period 1992-2004, 0 otherwise). Social Expenditure in the case of the center is Development Expenditure+ Transfers to the States, while Social Expenditure for the states is simply development expenditure.

[14]The Johansen-Juselius test indicated that the series in the equations are cointegrated, and that thus,further differencing of the series is unnecessary and the OLS regression can be carried out.

The results of the regressions, listed in tables (3.9) and (3.10) provide some additional evidence for the negative effects of the interest burden on expenditure for both states and the center, but especially for the former. A rise in the state interest payments to GDP ratio of 1% has a more than proportional negative impact on both development and capital expenditure. For the center, while interest payments do not have a statistically significant effect on expenditures, the period of liberalization appears to have been one in which interest expenditures did significantly squeeze development expenditures. The concurrent reduction in tax revenues from tax reforms meant that the fiscal squeeze was still felt.

To be sure, some of the reduction in expenditure has occurred because of changed priorities (defence spending, for example has seen no cuts). This analysis, however, suggests that liberalization did work so as to constrain such expenditures[15]. An initial hope was that development expenditure, especially in the form of infrastructural spending would be taken up by inflows of foreign capital. However, this has not come to pass.

These regressions are relatively simple and are meant to provide correlations between government expenditures and fiscal pressures.[16] All in all, the data is consistent with the notion that financial liberalization has increased interest rates and contributed to a fiscal squeeze in India (especially for the budgets of the states). While there is a matter of prioritization of expenditure, for the most part, governments may have chosen (or have been forced) to reduce development and capital expenditure. To the extent that it is the poor who

[15]As table 6 also shows, in the low interest rate era from 2000-2003, there has been a definite increase in development expenditure as a percentage of total expenditure.

[16]A more complete analysis might consider demographic effects, institutions and pay greater attention to causation and time-series effects.

benefit disproportionately from development and capital expenditure, this has a clear negative effect on distribution.

3.4 The McKinnon-Shaw Hypothesis in India

The McKinnon and Shaw hypothesis (McKinnon, 1973, Shaw, 1973) provided the fundamental theoretical impetus for policy makers in their support of liberalization. Indeed, the allocational benefits of a liberal financial regime were considered the major reason for the shift and as such, while the distributional consequences of financial liberalization are considerable (as has been argued from the previous sections), they were perhaps seen as of secondary importance. In order to evaluate the policy shift fairly then, some (brief) attention needs to be paid to its success in terms of the predicted effects on savings, intermediation and growth.

The McKinnon and Shaw thesis at its core suggests that the government uses financial repression as a source of captive funds and that the redressal of these distortions should result in more capital being freed for the private economy. Freeing the economy from sub-market interest rates would result in more savings, more efficient allocation of resources and hence more investment and output growth. By contrast, Taylor,1983 and more sophisticated later accounts (Rao, 1995) suggest that the final outcomes of financial liberalization on macroeconomic outcomes depends heavily on the linkages between the informal and formal credit markets. According to Taylor, the reserve requirements of the formal sector may reduce the total supply of funds to the whole economy as credit flows from the informal to the formal sectors. Just as importantly, the higher real interest rates would result in greater firm distress and a contraction in investment and aggregate demand.

The macroeconomic evidence on the merits of the McKinnon and Shaw arguments is at best mixed. The interest rate pattern appears to have followed the predicted patterns of an initial interest rate increase (from 1991 to 1996), followed by a steady decline thereafter. However, the reason for this decline was not as per the McKinnon-Shaw hypothesis(liquidity expansion through increased household savings and flows from the informal to the formal credit markets, followed by competitive decreases in the lending rates). Instead, much of this interest rate decline was due to active central bank intervention in releasing liquidity into the system (especially of foreign inflows). Despite the decline in inflation rates in the middle to late 1990s, lending rates of banks remained high and there were no competitive pressures to push these down. Active monetary management by the RBI was therefore crucial in reducing rates. As predicted by the McKinnon and Shaw thesis, it certainly true that the financial system has become deeper through the 1990s. From 1990 to 2000, the ratio of M2 to GDP rose from 40% to 52%- a rise of 30 percent, which compares favorably with the rise of 20% in the preceding decade[17].

This increased liquidity did not however translate into great levels of private investment. The private investment to gross domestic product ratio declined from 12% to 11% from 1990 to 1994 and has risen to and remained at about 12% since[18].There are two major reasons for this. First, banks have taken to procuring government securities which provided a safe and high return. This is, at some level, unsurprising since the state remained the major engine of aggregate demand through the nineties. The government spending to GDP ratio rose from 27% in 1990 to 37% in 2002[19]. Market borrowings from the

[17]Source: World Development Indicators.

[18]Source: Penn World Tables, 6.1[68].

[19]Source: Penn World Tables, 6.1.

government have consequently been very high. Given the high demand from the government bond market and the safe returns,in 2003 banks were holding close to a full 15% points more in government securities than they needed keep from statuatory requirements(40% rather than the requisite 25%)(EPW, 2003a). Equally importantly, industrial recession, partly brought on by high interest rates in the mid 1990s meant that there was a reduction in the demand for private investment borrowings.

The McKinnon-Shaw thesis also suggests that liberalization would improve access to formal credit. That is, liberalization eliminates credit queues and so allows access to bank funds for any borrower who is willing to borrow at the going rate. It is here that the thesis comes up against its most serious shortcomings in the case of India. As the evidence from the earlier sections suggest,there is substantial excess liquidity in the rural credit system, and there has been an active disintermediation of a large proportion of the population. Similarly, as some have noted (EPW, 2003a), small and medium borrowers are facing substantial credit constraints. Finally, there is evidence that there has been a flight of low-end borrowers to the informal sector. Ramachandran and Swaminathan, 2001 argue on the basis of field studies that:

> The 1990s have not just been a period when the share of informal sector loans in the debt portfolios of the poor increased sharply; they have also been a period over which the process of informalization of the credit market intensified (pp.15).

The reasons for this gap between demand for formal loans and their supply are not completely clear. Some authors (Varma, 2003, Banerjee et al, 2004) suggest that this reduction of credit availability is possibly because of over regulation. They argue that stringent anti corruption legislation prevents bank officers from extending loans to potentially risky clients. Others argue that in an era with a large demand for credit from the government, banks are happy to engage in 'lazy

banking'(EPW, 2003a), since the return on asset ratios for more risky low-end borrowers is low. Finally, others suggest that the role as agents of development that the banks played in the pre-liberalization period has been abandoned and that the competitive pressures unleashed make it difficult to lend to poorer borrowers.

A combination of these factors is possibly at work. In any case, the fact that the formal credit market is not in equilibrium(in the sense that there are unsatisfied borrowers at the going interest rate) is indisputable. As such, this finding should be seen as contradicting the McKinnon and Shaw prediction. There is perhaps a case to reintroduce mechanisms through which to compel banks to lend to worthy borrowers who are credit constrained in a liberal regime.

3.5 The Capital Market

As with any movement towards a market based system of finance, the experience of the Indian financial system has been one of increasing complexity and distinct changes of the financial market. If the summary of section(I) suggests that there has been a distinct contraction of financial intermediation in the agrarian economy and small scale industry, there has been an equal and opposite explosion in the availability of credit in urban India. Financial liberalization has resulted in the rapid development of a market based system of finance and a wide array of financial instruments. In addition, liberalization has resulted in the appreciation of asset prices, especially corporate securities and land held by the relatively affluent. It is to the consideration of these changes that I now turn.

3.5.1 Domestic Capital Market Reforms

A central concern noted in the Narsimham committee report was that the capital market was severely underdeveloped for an economy of India's size and complexity[20]. It proposed that the first steps towards developing such a resource for funds were to remove restrictions on the pricing and issues of capital in the Indian bourses and to set up a regulatory body in this regard. In 1993, the Securities Exchange Board of India (SEBI), an independent oversight body set up in 1988 had its powers decidedly increased by the passing of the SEBI act. In 1994, the National Stock Exchange, was established. The NSE was central to modernizing the capital market, introducing electronic trading and order matching. The reforms essentially broke the monopoly of Bombay Stock Exchange brokers in capital markets. In addition, there was an active encouragement of mutual funds through support to the alliance of mutual funds. Table 3.11, adapted from Bajpai, 2003 below summarizes some important domestic reforms in financial markets. These changes were rapid and were more or less all completed by 1998.

3.5.2 International Capital Market Reforms

Given the alacrity with which the domestic financial system was deregulated, the well- known sluggishness of reforms in external capital markets may seem surprising. In contrast to other countries undergoing liberalization in the same period (notably some East Asian economies and former Soviet Republics), India adopted a far more cautious approach to international financial deregulation: the last decade has seen a careful, gradual and as of yet incomplete deregulation of international capital flows.

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[20]As Echeverri-Gent , 2002 notes, these recommendations were very similar to an earlier set of recommendations of a World Bank team in 1985.

Some commentators have explained this as occurring because of the unwillingness of politically entrenched groups to forego rents. While this may have been contributory, it is at least equally the case that the gradualism of Indian deregulation was an active goal of policy makers (see Ahluwalia, 2002, Acharya, 2002), and the result of the lessons they had learned during the crisis of 1991.

The decade of the 1980s was one in which India had turned to (previously ignored) external capital markets for finance, in particular to commercial borrowing from non-resident Indians. Over the period, India, which had been one of the more reliable debtors in the developing world, amassed a large volume of debt, accounting for 31 percent of capital inflows by 1991-92. The 1990 BOP crisis was partly precipitated- and certainly exacerbated- by a wholesale withdrawal of funds and capital flight from the special commercial deposits of Non Resident Indians. By March 1991, the crisis had reached severe proportions, and with foreign reserves falling to a low of $ 1 billion, India had barely enough reserves to maintain two weeks worth of imports. The story that followed is a familiar one. India turned to the IMF for an emergency loan, and the resultant attached conditionalities led to the adoption of extensive liberalization measures and a movement towards a more free market economy.

The episode was not without its lessons for policy makers, however, and, indeed much of Indian Capital Account Management since then can be seen as dictated by the experience garnered in this period[21] . In the years following, Indian Authorities have been proactive in maintaining safeguards against financial instability, and reducing external vulnerability. As Nayyar, 2000 says in regard to the Indian initiation to reforms:

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[21]They have also been fortunate on two occasions when full capital account liberalization was pushed, to relearn from the misfortunes of other countries(the tequila crisis in 1994 and the Asian financial crisis in 1997), the potential difficulties of integrating with world capital markets.

> It prompted strict regulation of external commercial borrowing especially short-term debt. It led to a systematic effort to discourage volatile capital flows associated with repatriable non-resident deposits. Most important, perhaps, it was responsible for the change in emphasis and the shift in preference from debt creating capital flows to non-debt creating capital flows. (Nayyar 2000)

Crucially, the management of integration into the world financial market was based on fundamental asymmetries between residents and non-residents, and corporates and individuals. While non-resident corporates enjoyed substantial repatriability of funds, this was severely limited in the case of individual non residents. Resident corporates must obtain approval of various sorts before exporting capital, and resident individuals are, for all practical purposes subject to very strict controls with respect to these.

Given the experiences of the 1991 external crisis, there was a clear preference for some sorts of capital flows than others. For policy makers, there was a desire to be less dependent on debt inflows and more reliant on equity investment. Within the latter category, direct investment was considered superior to portfolio investment because of the volatility aspects associated with the latter.

To this end, the first element in the capital account to be decontrolled was Foreign Direct Investment in mid 1991.While the actual policy was not broad (international investors were allowed a 51% stake in a controlled set of sectors), symbolically it was a major event, since India had explicitly rejected FDI and multinational ownership of Indian assets in the late 1970s. These processes steadily moved forward, by 1993 when there were far reaching changes in the Foreign Exchange Regulation Act (FERA) of 1973. The policy granted equal status to both foreign and Indian-owned companies within Indian borders and began the process of liberalizing outward investments by Indian companies overseas. The process since then was somewhat more incremental, as more sectors were added to the open FDI list, and ownership ceilings were slowly but surely

gradually lifted. Some of these reforms may have been used to guide FDI into certain industries, and it is certainly true that much of FDI was channeled into priority sectors such as computer hardware and software, engineering industries, services, electronics and electrical equipment, infrastructural projects, chemical and allied products, and food and dairy products.

The attitude towards portfolio investment has been equally gradual, although the development of a much larger market for currency and the development of a better-regulated stock market should also be seen as contributing to its increase. India's first attempt to capture part of the growing funds being channeled into emerging markets came during the second half of the 1980s, as India opened five closed-end mutuals for sale on offshore markets. These did not turn out to be central in attracting portfolio investment into India, and it was only after the initiation of the reform process that this process took off. In 1992, the first landmark legislation was introduced, with Foreign Institutional Investors being allowed to invest with full repatriability of proceeds, in a controlled manner, and with a controlled ceiling of shares being owned. In order to provide some legitimation of the process, the government set up an independent board, SEBI (Securities Exchange Board of India) that was charged with the regulation of foreign equity flows. The Bombay stock exchange (BSE), was, till the mid nineties, the premier stock exchange in India, and had a well deserved notoriety for lacking transparency and requiring relationships with powerful brokers to achieve quick settlements of orders (see Gent 2002 for more details). SEBI and the GOI attempted to redress this by creating the National Stock Exchange (NSE). Due to various factors, including breadth of coverage, modernized trading tools and the creation of a clearing system, NSE quickly became the largest stock exchange in the Indian financial market. In 1997, the American Securities Exchange Commission nominated the NSE as an eligible foreign custodian, which

allowed foreign firms to invest with security. In the interim, the GOI also permitted (subject to their approval) the issuing of shares by domestic companies in foreign markets. These were the so-called American Deposit Receipts and the Global Deposit Receipts that contributed to the large inflows of foreign exchange into the country in the mid 1990s. By the late 90s, the limits on FII ownership of share capital had been lifted (although not to having majority stakes in most sectors).

Commercial borrowing in contrast to the other two elements of capital account liberalization has been quite remarkably curtailed. Again, this can best be seen as a result of the various lessons learned about debt in general and short term debt in particular. Commercial banks, unlike in some East Asian countries, have not been and are still not allowed to accept deposits or to extend loans which are denominated in foreign currencies. There is a small component of commercial borrowing, for limited amounts or specified maturities, which are based on a simplified procedure of automatic approval by the Reserve Bank of India. Most of commercial borrowing however required case-by-case approval from the government, and much of short-term debt was carefully regulated. The primary source of commercial debt in the 1980s, from Non Resident Indian deposits schemes, have been curtailed through the 1990s. The RBI no longer covers exchange rate risk and does not offer interest rate premia to NRIs.

Another element of financial regulation that has remained in the control of the. government has been exchange rate policy. As authors have suggested, much of India's intervention in external capital markets has been to maintain the stability of the exchange rate. Part of this is to do with the fact that Indian foreign currency markets are rather thin and therefore subject to volatility. While explicitly abandoning the dual exchange rate regime in 1992-1993, the RBI has had to manage the exchange rate through other means in order to prevent

the large surges of inflows (and equally large outflows in 1997) from disrupting macroeconomic stability.

3.6 Capital Market Liberalization and its Distributional Effects

Capital market liberalization began in earnest in 1993 with the SEBI act. The BSE sensex index which stood at 900 points in July 1990 currently stands at 6600 points at the end of 2004[22]. The total market capitalization in the Bombay Stock Exchange (BSE) was less than Rs.100,000 crores in 1990. Fourteen years later, the aggregate market capitalization of the BSE and NSE (which came into existence in 1995) exceeds Rs. 1,200,000 crores, or an average increase of about 100 per cent a year during the 1990s (even after taking into account the 1994 and 1998 crashes). At the same time, the Indian economy has grown at about 6 % per annum.

Another measure of the explosion in finance accruing to the capital market is provided by looking at the ratio of market capitalization at the BSE to the assets of scheduled commercial banks. The ratio rose from 15% to 80% between 1985 and 2000 (see table (3.12)

What are the proximate causes of this surge? Some of this change reflects the increase in the holdings of shares and debentures on the part of households. Table (3.13) below suggests that following liberalization there has been a decidedly greater interest in shares and debentures as a savings vehicle. The figures shown are certainly an underestimate of the amount of finance channeled towards the

[22]Much of this appreciation has occurred in the last four years, as the restrictions on international capital mobility have become even fewer.

stock market given that mutual funds are sources of indirect investment into the stock exchange.

This being said, the stock market scam of 1992, in which Rs.54 billion of banking funds were diverted to artificially inflate stock prices had a very strong negative effect on investment in shares by households.Scams in the stock market and in the bond market have continued to deter households over the years (cf Shah and Thomas, 2002. In 1994, the M.S Shoes case resulted in a default of Rs. 170 billion, in 1995 the Sesa Goa and Rupangi cases resulted in losses of Rs. 60 million, in 1997 the CR Bhansali case involved losses of Rs. 70 billion. In 2001 another stock market scam, this time involving external speculators erupted. Ketan Parekh- a speculative broker, and several overseas corporate bodies conspired to rig share prices by investing from overseas accounts in Mauritius. Partly as a consequence of these scams, while the period 1990-1994 saw a large increase in ownership of shares and debentures in households (at the expense of deposits), 1995-2000 saw a sharp decrease in the share of financial assets held directly as shares and debentures owned by households.

Another cause for the surge in the stock market is external deregulation and the permitting of foreign institutional investment. The number of registered foreign institutional investors in the stock market rose from 18 in 1993 to 540 in 2004. These investors have brought in over Rs. 100,000 Crore into the Indian stock market since 1992, or over a fifth of private non financial companies market capitalization. This increase in portfolio investment has been most pronounced in the last few years, and is considered by many to be central to the most recent run up of stock prices. Kohli , 2003 finds a strong positive correlation between foreign portfolio investment and Indian stock price indices.

Finally, the opening up of the market to private mutual funds also meant a large increase in finance channeled into the stock market. In the last five years

especially, private mutual funds were able to obtain resources which exceeded resources mobilized by UTI and Bank Sponsored Funds. In 2004, private sector mutual funds obtained resources of over 42,000 crore or over 90% of all resources mobilized by mutual funds.

Given that the stock market has seen a vast increase in both in its valuation and its scope, it is useful to assess the distribution of stock ownership in India. What percentage of the Indian population has access to the stock market and benefits from its appreciation? Unfortunately, there are no time series available on the stock holder population of India over a long period of time. However, the few studies that have taken place provide some indication of the changes in stock ownership.

It is certainly the case that the investing population of India has grown between the 1980s and now (Sen and Vaidya, 1997). In addition, the distribution of share ownership in terms of geographical location of investors has become less concentrated in urban areas . This said, the stocks remain an asset that is owned primarily by the elite. The Society for Capital Market Research and Development carried out three surveys of household investors from 1990 to 1997, showing an increase in the total number of share owners from about 10 million to 20 million over the period (or about 1-2 percent of the population). In another survey done by the SEBI and NCAER,(SEBI-NCAER, 2000, 2003) the proportion of all households in India who invest in the stock market was about 7.5%, with about 15% in urban areas and 4% in non urban areas investing in shares. The percentage of the population which invested in mutual funds was higher at about 10% of all households (see tables (3.14)-(3.17).

The SEBI-NCAER survey shows that the holding of shares, debentures and bonds, as might be expected, increases monotonically with the level of income of the household. As the table 3.17 below shows, households who earn more than

Rs. 15,000 per month are about fifteen times more likely to hold UTI schemes or Mutual Funds and about seven times more likely to hold bonds, but only fifty percent more likely to hold fixed deposits than households that earn up to Rs. 2,500 per month. In addition, urban households invested more in non- fixed deposit assets compared to rural households.

In an interesting analysis, Rao, 2004 measures the share of different categories of shareholders in total market capitalization at the BSE. The table below shows the share of the total market capitalization of non-government listed companies by five groups: Indian and foreign promoters, institutional investors, private corporate bodies and the general public from the study. The data suggest a strong concentration of ownership with promoters and with institutional investors (particularly foreign institutional investors). In addition, Rao finds that it is in precisely the most highly traded and larger companies that this concentration is highest, suggesting that promoters and foreign institutional investors have gathered the lion's share of the appreciation of equity. The pattern of sources of funds for non public, non financial companies suggest, also, that external funds as a percentage of total funds went from about 58% in 1985 to 72% in 1995 and down to about 35% in 2003 (RBI-Handbook of Indian Statistics, 2004)(see table (3.18)).These facts provide some support for the idea that rather than acting as a vehicle for companies to access funds from the general public, the stock market appears to be increasingly geared towards attracting foreign portfolio investment and appreciating scrips owned primarily by the promoters.

3.7 Other Distributional Effects

3.7.1 Wage Inequality and Foreign Direct Investment

A standard channel by which international financial openness may sharpen inequality is by increasing wage disparities between skilled and unskilled work-

ers. If foreign direct investment flows into industries which possess a higher than average skill set, a higher relative demand for skilled labor will result in increasing wage inequality (Markusen and Venables, 1997). Despite the neo-classical prediction that developing countries should see FDI inflow into low skill industries, much evidence across several countries suggest that relatively high skill industries see FDI inflows (Feenstra and Hanson, 1995 for Mexico, Zhao, 2001 for China, Matsuoka , 2002 for Thailand)

Evidence of rising wage inequality in India has begun to accumulate and be taken seriously. Galbraith et al, 2004 use data from the Annual Survey of Industries from 1983-1998 to suggest that pay inequality across industries and across regions has risen following the reform process. Dutt and Rao, 2001 write:

> There is anecdotal evidence on rapid rates of increase in the incomes of highly-skilled workers and managers in the 1990s, especially in transnational corporations. These increases are especially among those who are graduates of leading management and technology institutes, suggesting increases in the skilled-unskilled wage differential. However, we know of no aggregate data confirming this trend.

In a very recent paper, Banga, 2005 provides evidence for this trend. Using panel data on 78 industries at the three-digit level of industrial classification (National Industrial Classification) for the period 1991-92 to 1997-98, she finds that FDI, as measured by the share of foreign companies in total sales of the industries has a significant positive effect on the difference in the wages of skilled versus unskilled labor.

While work on the topic is still preliminary, the result suggests that India has not been able to attract FDI into its low-skill export oriented sector. In the absence of an impetus to this sector, given a limited supply of skilled labor, the skill based wage disparities arising due to FDI may be expected to grow.

3.7.2 Consequences of Foreign Investment on Land Prices

One should not ignore one of the less studied distributional consequences of financial liberalization (especially international liberalization and the inflow of foreign capital): the effects on urban land prices. Nagaraj, 1997 and Nijman, 2000 suggest that the latter has been among the most important forces behind the rise in commercial land values. Although legislation meant that foreign firms were not allowed to own property, the inflow of multinational firms as renters resulted an explosion in the real estate industry as developers expanded production rapidly in anticipation of high rental values. While there are no good data on the distribution of land in urban areas due to poor accounting practices, it cannot be doubted that the bulk of land and especially commercial property is owned by the relatively well off groups in society. The period from 1990 to 1996 saw an explosion in the value of land assets in the urban core. Following this, there was a tapering off of land prices till 2000 followed by a period of stabilization. Currently, in all the metros commercial land is about three and a half times its value pre 1990.

The table (3.19) below suggests the impact of foreign capital as it entered Mumbai and Delhi during the initial years of liberalization and secondary metros like Bangalore in the last four years.

To summarize, therefore, financial liberalization and increased openness have led to a vast increase in the size, scope and valuation of the capital market in India over the last few years. Despite the perils of integration, prudential regulations have kept net capital inflows positive throughout the 1990s and India did not experience a financial crisis in a decade which saw at least four debilitating currency crises across developing economies in the rest of the world. The solid and relatively rapid development of a sophisticated market based financial system with a wide variety of asset vehicles and strong growth over the last

decade is certainly something that should be commended, but its benefits for the majority of India's population should not be overstated.

The limited evidence suggests that despite a growth in the investing population, it is a small proportion of households which hold stock market assets both directly and indirectly. Also, about half of the assets in the stock market are owned by promoters (and only about one fifth of the stock market is owned by the general public), suggesting that the majority of capital gains accrue to a very small group of the population. In addition, the stock market is increasingly dependent on and therefore vulnerable to foreign capital. Finally, given the relatively small section of the population that it directly benefits, the stock market has grown to have a disproportionate political importance. In May 2004, following the upset election in which the right wing nationalist BJP party was defeated by a coalition of the Congress and leftist parties in the general elections, there was a sharp fall in the stock market and strong protests from brokers and institutional investors. The Congress in turn rushed to reassure investors that it had no plans to return to the state control of the past and even substituted the (apparently) left leaning Sonia Gandhi for the pro-reform Manmohan Singh as prime minister. The episode has much to say about the now firmly established importance of the stock market as an agent in Indian political economy.

3.8 Conclusion and Extensions

The empirical results from the previous sections strongly suggest that financial reforms have coincided with unequalizing processes in terms of access to and holding of resources in each of the circuits of finance considered. Causality is more difficult to establish convincingly. For example, it is certainly the case that changes in financial regulations have made it easier for banks to ignore lower end borrowers, but the reduction in credit flowing to such borrowers may also

be simply a reflection of the lack of credit worthy projects. This being said, the broad trends depicted militate strongly against the ideas promoted by some (eg. Bhalla 2003) that inequality in India has fallen as a result of reforms[23].

The empirical trends from this chapter suggest that financial and particularly banking sector reforms have been linked with widespread financial disintermediation for the rural sector, for agriculture, for small scale industry, for small borrowers and in the poorer states. There is solid evidence of increasing movement to informal financing for these sectors. Indirectly, higher interest rates during the period have also hurt the poor disproportionately by precipitating a fiscal squeeze on the state's ability to make productive capital and development expenditure. Finally, domestic and international financial liberalization has led to the rapid development of the market based financial system which has unequivocally benefited the richer sections of society both in terms of increased efficiency as well as increased access to finance. While these trends are not in and of themselves evidence of growing inequality, it is very hard to reconcile these findings with either falling poverty or inequality.

What conclusions can be drawn then for policy makers? The story of Indian financial reforms provides a strong warning about the difficulty of addressing social concerns in the presence of incessant demands for efficiency (narrowly defined as profitability of banking), and for the development and maintenance

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[23]Much has been written about the lack of clarity in data about inequality and poverty in India. Trends between 1990 and 1997 in NSS surveys showed an increasing in both rates of poverty and inequality. However, the 55th round (1999) based on a different methodology, showed a sharp decline in both these rates. The strong controversy around this finding was, it seemed for a time, mitigated by statistical adjustments by Deaton and Dreze, 2002 and Sundaram and Tendulkar, 2003 which suggested that poverty and inequality had indeed decreased. More recently, work by Sen and Himanshu, 2004 indicate that the adjustments were incorrect and that in fact, inequality and poverty have most likely increased in the period in question.

of a market based financial system. In addition it also gives an indication of the importance of fiscal squeeze and the constraints placed on the state under a liberalized regime. To the extent that policy makers are concerned about these issues, at least certain aspects of finance may need to retain regulation and regular oversight. For example, development finance and rural banking may need to be augmented yet again, and priority sector lending requirements reworked so as to direct stable credit towards those sectors and groups most in need of it.

The ignoring of the real issues of deprivation facing the poor (of which the consequences of financial reforms are but one) has resulted in a political backlash. The new government in 2004 was elected on the back of massive rural disenchantment with the previous policies. It has already suggested that its priorities are more directed towards these constituencies. If this is truly to be the case, the regulatory structure of finance in the economy should certainly see a few changes in the coming months and years.

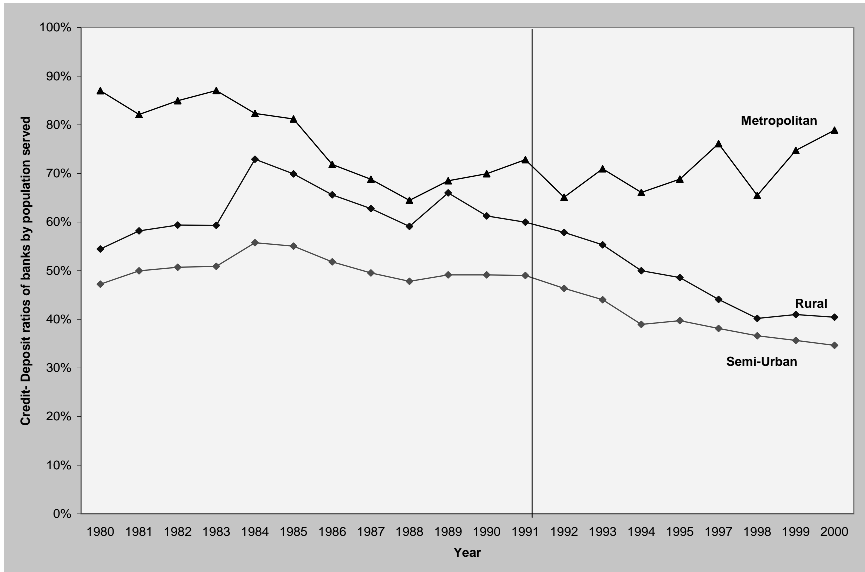

Figure 3.1. Credit Deposit Ratios by Rural and Urban Sectors

Source: Author's calculation based on RBI statistics

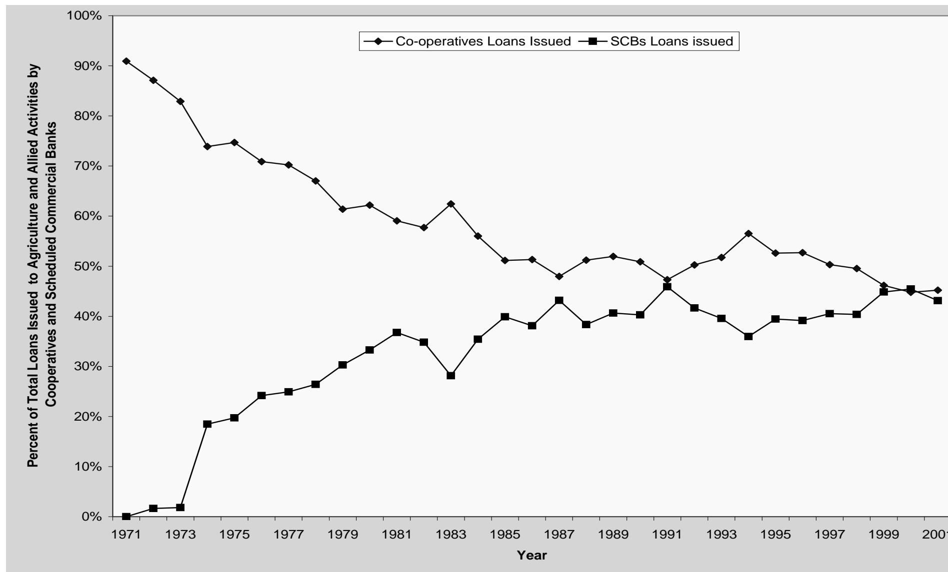

Figure 3.2. Credit to Agriculture and Allied Activities by Banking Intermediary.

Source: Author's Calculation based on RBI statistics

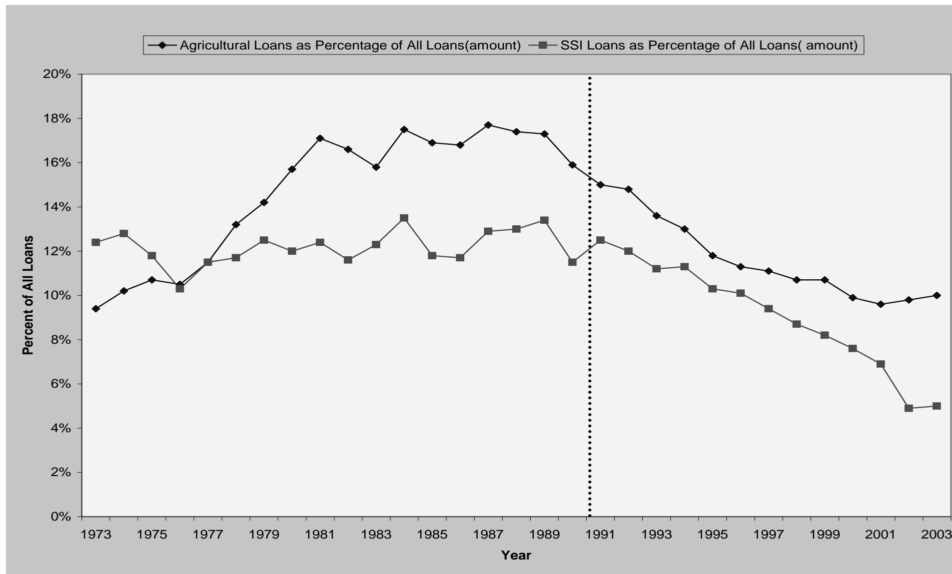

Figure 3.3. Declining Credit to Agriculture and Small Scale Industry Following Reforms

Source: Author's Calculation based on RBI statistics

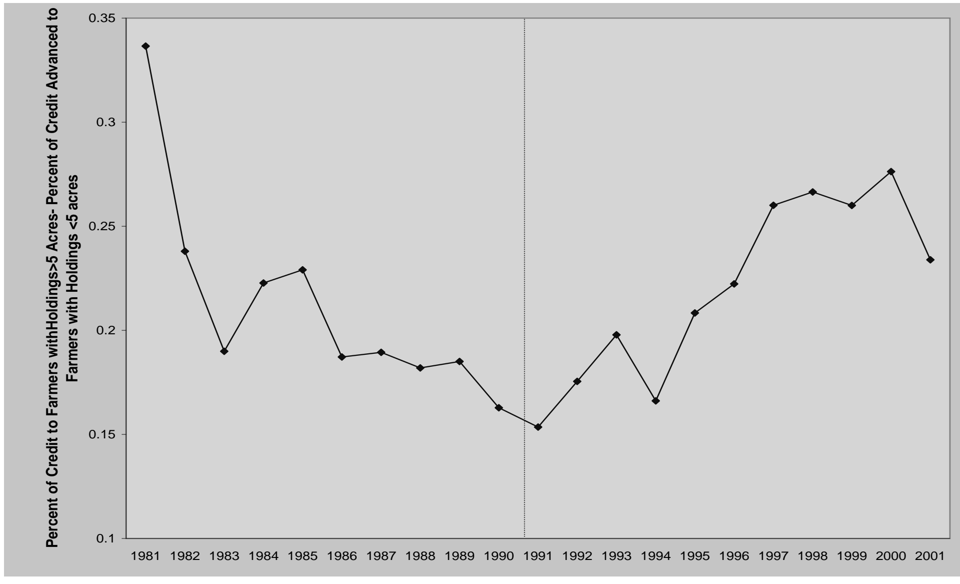

Figure 3.4. Credit to Small and Large Farmers Pre and Post Reforms.

Source: Author's Calculation based on RBI statistics

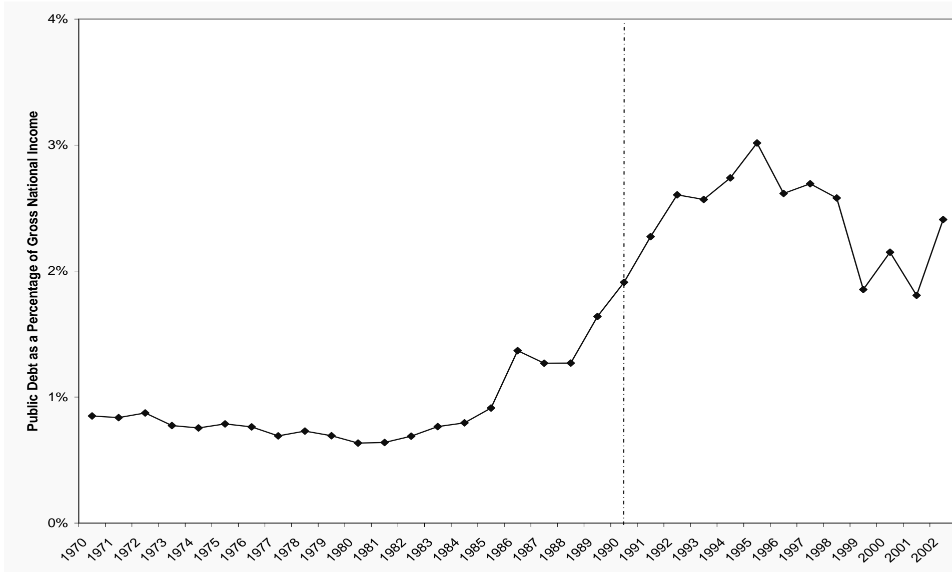

Figure 3.5. Public Debt in India

Source: World Development Indicators

Table 3.1. Recommendations of the Narsimham Committee and Enactment of Policy

Policy Proposal	Enactment
Reduction in SLR	The SLR was progressively reduced from 38.5% in 1992 to the suggested 25% in October 1997 where it remains to date.
Reduction in CRR	The CRR was progressively reduced from 15% in 1991 to 4% in 2002.
Priority Sector Lending	The 40% rate for priority sector lending remains unchanged, the definition of industries included in the priority sector, however seen a substantial increase in the sectors covered under such lending.
Competition	Approval was given by the RBI for the establishment of new banks in the private sector in 1992.
Branch Licensing	Branch Licensing was considerably liberalized in 1993.
Interest Liberalization	Interest Rates match market rates more closely. The lending rate was rationalized into three categories in 1993. The minimum lending rate on selective credit was abolished in 1996.

Table 3.2. Average Annual Growth Rate in Number of Bank Branches

Area	**1980s**	**1990s**
Rural	8.9%	-0.6%
Semi Urban	3.4%	2.5%
Urban	4.5%	2.3%
Metro	3.6%	4.1%

Source: Author's calculation from RBI statistics (www.rbi.org.in)

Table 3.3. Trends in Small Borrowal Accounts

Year	Small Borrowal Accounts as percentage of all accounts	Share of SBA in all credit advanced
1984	95.5%	20.5%
1985	95.6%	20.1%
1986	95.8%	22.5%
1987	95.8%	24.2%
1988	95.4%	25.4%
1989	95.0%	23.2%
1990	94.9%	22.0%
1991	94.9%	22.0%
1992	95.0%	21.9%
1993	94.2%	19.8%
1994	93.6%	18.3%
1995	92.8%	16.2%
1996	91.6%	14.2%
1998	87.5%	12.5%
1999	81.6%	10.0%
2000	72.2%	6.4%
2001	71.1%	7.0%
2002	66.3%	5.3%

Source: Author's calculation from RBI statistics (www.rbi.org.in)

Table 3.4. Trends in Credit-Deposit Ratio in BIMARU states and All India

	1985-1990	1990-1995	1996-2000
All India Average	61.3%	58.2%	55.8%
BIMARU* Average	58.3%	53.1%	40.1%
Difference	3.0%	5.1%	15.7%

*BIMARU= Bihar, Rajasthan, Uttar Pradesh, Madhya Pradesh, Orissa
Source: Authors calculation based on RBI statistics

Table 3.5. Interest Rates in India

Year	SBI Advance Rate	GOI Short Term	GOI Medium Term	GOI Long Term
1980	16.5	4.70-5.74	5.70-6.30	6.20-6.98
1981	16.5	4.74-6.01	5.80-6.75	6.44-7.49
1982	16.5	5.32-6.43	5.81-7.02	6.45-8.00
1983	16.5	4.98-8.46	6.25-7.77	6.46-9.00
1984	16.5	4.50-7.08	6.67-9.04	6.47-10.00
1985	16.5	4.20-8.31	6.47-9.04	7.93-10.50
1986	16.5	5.42-9.84	6.49-9.50	8.38-11.50
1987	16.5	5.09-11.60	6.50-10.86	8.88-11.50
1988	16.5	6.86-15.78	6.51-11.73	9.17-11.50
1989	16.5	7.03-23.88	6.76-13.77	9.36-11.73
1990	16.5	7.56-18.36	7.69-15.06	10.05-11.80
1991	16.5	7.04-21.70	9.44-12.70	10.86-12.04
1992	16.5	8.37-26.26	9.50-13.42	9.91-12.38
1993	19	9.08-23.77	9.50-14.78	8.82-12.47
1994	19	11.86-12.86	12.70-13.30	12.85-13.43
1995	15	9.75-11.76	11.30-13.86	11.77-13.47
1996	16.5	6.00-14.28	5.75-14.07	11.84-13.02
1997	14.5	5.21-16.21	5.75-14.44	9.00-14.20
1998	14	5.50-17.69	5.20-14.00	9.00-13.17
1999	12-14	4.45-17.73	5.75-13.74	10.00-13.46
2000	12	3.18-14.30	6.50-13.84	9.79-13.11
2001	11.5	4.94-16.66	9.37-12.50	10.58-11.89
2002	11.5	5.32-10.96	5.14-13.85	7.41-10.86
2003	10.75			

Source: Reserve Bank of India

Table 3.6. Fiscal Deficit, Tax Revenues and Interest Payments

Year	Gross Fisc. Deficit as % GDP	Gross Tax as % of GDP	Int.Payments as % of GDP
1980	5.29	9.91	1.9
1981	5.77	9.15	1.8
1982	5.14	9.38	1.9
1983	5.64	9.38	2.09
1984	5.94	9.42	2.18
1985	7.09	9.54	2.43
1986	7.86	10.3	2.7
1987	8.47	10.54	2.97
1988	7.63	10.61	3.18
1989	7.34	10.54	3.39
1990	7.33	10.61	3.65
1991	7.85	10.11	3.78
1992	5.56	10.3	4.07
1993	5.37	9.96	4.15
1994	7.01	8.82	4.28
1995	5.7	99.11	4.35
1996	5.07	9.36	4.21
1997	4.88	9.41	4.35
1998	5.84	9.14	4.31
1999	16.51	8.26	4.47
2000	5.41	8.87	4.66
2001	5.65	8.96	4.72
2002	6.14	8.15	4.68
2003	5.9	9	4.69

Source: Reserve Bank of India

Table 3.7. Selected Components of Central Government Receipts and Expenditures

Year	Tax Revenue as% of Receipts	1.Of which: Direct Taxes*	2.Of which: Indirect Taxes**	Int.Paid as% of Expenditures	Fiscal Index
1980	51.8%	11.8%	40.0%	12.1%	0.034
1981	46.1%	9.3 %	36.8%	11.4%	0.031
1982	48.3%	10.5%	37.8%	12.6%	0.031
1983	44.7%	9.3%	35.3%	12.8%	0.031
1984	45.3%	9.2%	36.1%	13.5%	0.032
1985	44.3%	8.5%	35.8%	13.7%	0.031
1986	44.6%	7.8%	36.8%	14.3%	0.034
1987	44.5%	7.4%	37.1%	14.7%	0.033
1988	44.9%	6.6%	38.3%	16.5%	0.034
1989	45.9%	8.2%	37.7%	18.0%	0.030
1990	46.6%	7.3%	39.3%	19.1%	0.028
1991	45.7%	7.3%	38.4%	20.4%	0.023
1992	47.9%	9.7%	38.2%	23.9%	0.018
1993	49.0%	10.9%	38.0%	25.3%	0.012
1994	40.8%	9.6%	31.3%	25.9%	0.003
1995	42.2%	11.5%	30.7%	27.4%	0.004
1996	48.6%	13.2%	35.4%	28.1%	0.007
1997	49.9%	13.5%	36.4%	29.6%	0.005
1998	41.1%	11.7%	29.4%	28.3%	0.000
1999	37.4%	11.5%	25.9%	27.9%	-0.00
2000	43.2%	13.9%	29.2%	30.3%	-0.004
2001	41.8%	15.0%	26.9%	30.5%	-0.001
2002	36.9%	13.4%	23.5%	29.6%	-0.006
2003	40.6%	15.1%	25.5%	28.6%	-0.03
2004	42.0%	15.9%	26.0%	28.1%	-0.02

*Direct Taxes= Income+Corporate Taxes
*Indirect Taxes= Excise+Customs Duties
Source: Reserve Bank of India

Table 3.8. Selected Components of Expenditure in the States and Centre of India

	Interest Payments as% of Total Expenditure		Dev.Expenditure as% of Total Expenditure		Cap. Expenditure as% of Total Expenditure	
Year	State	Centre	State	Centre	State	Centre
1981	5.4%	11.4%	70.4%	57.5%	34.7%	36.7%
1982	5.7%	12.6%	71.4%	52.2%	32.2%	39.0%
1983	5.9%	12.8%	71.8%	50.7%	29.6%	39.1%
1984	5.9%	13.5%	71.5%	51.4%	29.0%	37.4%
1985	6.2%	13.7%	70.1%	59.6%	28.9%	36.5%
1986	6.6%	14.3%	70.7%	61.2%	27.0%	35.6%
1987	7.9%	14.7%	71.1%	54.8%	26.5%	35.1%
1988	8.2%	16.5%	70.9%	51.9%	24.7%	32.4%
1989	8.8%	18.0%	70.0%	50.9%	22.1%	31.6%
1990	9.4%	19.1%	69.2%	56.9%	21.6%	30.9%
1991	9.5%	20.4%	69.6%	54.3%	21.2%	30.2%
1992	10.1%	23.9%	69.1%	51.8%	20.1%	26.1%
1993	11.1%	25.3%	67.5%	51.9%	19.4%	24.4%
1994	11.7%	25.9%	66.4%	49.6%	18.8%	23.7%
1995	12.0%	27.4%	64.6%	50.1%	20.5%	24.0%
1996	12.4%	28.1%	64.7%	46.1%	18.3%	21.5%
1997	12.6%	29.6%	65.1%	45.6%	16.7%	20.9%
1998	13.2%	28.3%	63.7%	46.5%	18.2%	22.3%
1999	13.5%	27.9%	61.8%	47.7%	17.4%	22.5%
2000	14.4%	30.3%	59.7%	42.1%	16.9%	16.4%
2001	14.9%	30.5%	60.6%	41.4%	16.0%	14.7%
2002	16.1%	29.6%	58.9%	42.5%	17.5%	16.8%
2003	16.8%	28.6%	57.1%	44.6%	17.6%	15.4%

Source: Reserve Bank of India,RBI statistics

Table 3.9. Dependent Variable:Capital Outlay as a Percentage of GDP

	Center	States
Tax Receipts by GDP	0.33 (2.4)	0.34* (10.3)
Interest Payments by GDP	-0.10 (-.92)	-1.01* (-8.12)
Tax Receipts by GDP X Lib	-0.19 (-.60)	0.02 (0.14)
Interest Payments by GDP X Lib	-0.34 (-.57)	1.07* (6.19)
Liberalization	0.02 (0.54)	-0.02 (-1.5)
N	32	32
Adjusted R-squared	0.76	0.83

*= signficant at the 1% level, t statistics in parentheses

Table 3.10. Dependent Variable:Development Outlay as a Percentage of GDP

	Center	States
Tax Receipts by GDP	2.99 (2.35)	2.05** (13.6)
Interest Payments by GDP	-0.58 (-.72)	-1.76* (-3.11)
Tax Receipts by GDP X Lib	-4.06 (-2.46)	-0.73 (3.11)
Interest Payments by GDP X Lib	-4.5 (-1.92)	1.5 (1.96)
Liberalization	0.46 (2.8)	0.02 (0.04)
N	32	32
Adjusted R-squared	0.76	0.89

*= significant at the 1% level, t statistics in parentheses

Table 3.11. Changes in Domestic Regulations for Capital Market

Element	1992	2003
Regulation	Gov. Oversight	SEBI
Intermediaries	Some regulated intermediaries (stock brokers, authorized clerks)	A variety of specialized intermediaries emerged.They are registered and regulated by SEBI. They as wellas their employees follow a code of conduct and are subject to a number of compliances.
Access to Market	Granted by Central Government.	Eligible issuers access the market after complying with the issue requirements.
Pricing of Securities	Determined by Central Govt.	Determined by Market.
Access to International Market	None.	Corporates allowed to raise ADRs/GDRs.International financial institutions allowed to trade.
Corporate Compliance	Few rules.	Emphasis on disclosure.
Mutual Funds	Restricted to public sector.	Open to private sector.
Anonymity in Trading	None.	Complete.
Form of Settlement	Physical.	Mostly electronic.
Derivatives Market	Absent.	Well developed.

Note: Assets of scheduled commercial banks includes liquid reserves, loans, investments and other assets. SCB=Scheduled Commercial Bank, BSE=Bombay Stock Exchange.
Source: Reserve Bank of India and Bombay Stock Exchange.

Table 3.12. Assets of Scheduled Commercial Banks and Market Capitalization at BSE as percent of GDP

at end of	(I)Assets of SCBs	(II)Market Capitalization at BSE	(II)/(I)
Dec-85	46.8	7.40	15.2%
Mar-91	56.3	16.0	28.4%
Mar-92	52.9	49.5	93.5%
Mar-93	51.6	28.2	54.7%
Mar-94	52	42.8	82.3%
Mar-95	51.6	43.1	83.5%
Mar-96	52.3	44.5	85.2%
Mar-97	50.9	34.1	66.9%
Mar-98	54.4	37.0	67.9%
Mar-99	56	30.9	55.3%
Mar-00	59.1	46.8	79.3%

Table 3.13. Percentage of Financial Assets of Household Sector Accounted for by:

Year	Shares and Debentures	Units of UTI	Total
1972-1975	0.4%	0.6%	1.0%
1975-1980	1.5%	0.4%	1.9%
1980-1985	3.3%	0.7%	4.0%
1985-1990	3.9%	1.1%	5.0%
1990-1995	8.7%	1.5%	10.2%
1995-2000	5.1%	1.9%	7.0%
2000-2003	4.0%	2.4%	6.5%

Source: Author's Calculation based on RBI statistics.

Table 3.14. Percentage of Financial Assets of Household Sector Held as:

Year	Shares and Debentures	Units of UTI	Total
1991	10	6.9	16.9
1992	10.9	14.6	25.5
1993	12.6	8.6	21.2
1994	10.6	5	15.6
1995	11.2	3.2	14.4
1996	8.4	0.2	8.6
1997	4.7	2.7	7.4
1998	3	0.4	3.4
1999	2.8	1	3.8
2000	7.9	0.9	8.8
2001	5	-0.4	4.6
2002	3.8	-0.7	3.1
2003	2.8	-0.6	2.2

Source: Handbook of Indian Statistics, 2004

Table 3.15. Investment by FIIs

Year	No. of FIIs	Net Inv. (Rs. Crore)	Net Inv. (US$ Millions)	Cumulative Net Inv.($ US Millions)
1993-94	158	5,126	1,634	1,638
1994-95	308	4,796	1,528	3,167
1995-96	367	6,942	2,036	5,202
1996-97	439	8,574	2,432	7,634
1997-98	496	5,957	1,650	9,284
1998-99	450	-1,584	-386	8,898
1999-00	506	10,122	2,339	11,237
2000-01	527	9,934	2,159	13,396
2001-02	490	8,755	1,846	15,242
2002-03	502	2,689	562	15,805
2003-04	540	45,767	9,950	25,755
Total		1,07,089	25,755	25,755

P. Provisional
Source:RBI

Table 3.16. Net Resources Mobilized by Mutual Funds(Rs. crore)

Year	UTI	Bank Sponsored Mutual Funds	FI Sponsored Mutual Funds	Private Sector Mutual Funds	Total
1981-82	157.4	-	-	-	157.4
1982-83	166.9	-	-	-	166.9
1983-84	330.2	-	-	-	330.2
1984-85	756.2	-	-	-	756.2
1985-86	891.8	-	-	-	891.8
1986-87	1261.1	-	-	-	1261.1
1987-88	2059.4	250.3	-	-	2309.7
1988-89	3855.0	319.7	-	-	4174.8
1989-90	5583.6	888.1	315.3	-	6786.9
1990-91	4553.0	2351.9	603.5	-	7508.4
1991-92	8685.4	2140.4	427.1	-	11252.9
1992-93	11057.0	1204.0	760.0	-	13021
1993-94	9297	148.1	238.6	1559.5	11243.2
1994-95	8611	765.5	576.3	1321.8	11274.6
1995-96	-6314	113.3	234.8	133.0	-5832.9
1996-97	-3043.0	5.9	136.9	863.6	-2036.7
1997-98	2875	236.9	203.4	748.6	4063.9
1998-99	170	-88.3	546.8	2066.9	2695.4
1999-00	4548	335.9	295.5	16937.4	22116.8
2000-01	322	247.8	1272.8	9292.1	11134.7
2001-02	-7284	862.8	406.8	16134.1	10119.7
2002-03 P	-9434.1	1033.4	861.5	12122.2	4583.0
2003-04 P	1049.9 *	2634.6	1126.7	42872.8	47684.0

Table 3.17. Distribution of All Households in Instruments by Income Class (% of all households)

Income per month (Rs.)	UTI Scheme	Mutual Funds	Fixed Deposit	Bonds
Upto 2500	2.4	1.8	65.0	3.4
2501-5000	6.4	4.3	81.3	5.3
5001-10000	19.0	12.0	88.3	11.1
10001-15000	31.9	17.9	90.2	16.0
Above 15000	33.9	20.7	93.8	21.5
Urban	40.6	31.0	92.7	33.4
Rural	13.8	14.0	92.3	14.3

* Since one household may invest in more than one instrument, percentage distributions of households will add up to more than 100.
Source: SEBI-NCAER Survey of Indian Investors, June 2000.

Table 3.18. Share of Different Categories of Shareholders in Market Capitalization in 2003

MCAP of 2,507 Non-Government Companies	Rs. Crore 4,40,160	Percentage 100%
Owned by:		
1) Indian and Foreign Promoters	2,10,597	47.5%
2) Institutional Investors	1,08,281	24.6%
a) FII's	53,741	12.2%
b) Banks and Financial Institutions	30,506	6.9%
c) Mutual Funds	24,033	5.4%
3) Private Corporate Bodies	17,852	3.9%
4) General Public	79,086	17.9%

Source: Rao, 2004

Table 3.19. Central Business District - Capital Value Rs.Per Square Foot

Year	Mumbai,Nariman Point	Delhi	Bangalore
1990	3000	3500	750
1991	3500	3500	800
1992	6000	4500	950
1993	7000	5200	1500
1994	15000	15000	1500
1995	25000	18000	2050
1996	22000	13000	2000
1997	20000	13000	2000
1998	18000	11000	2000
1999	15000	9000	2250
2000	17000	8500	3000
2001	13000	8200	3000
2002	11000	8200	3000
2003	10000	8200	3500
2004	10000	8200	3800

Source: CB Richard Ellis, India Market Brief, Various Issues.

CHAPTER 4

AN ASSESSMENT OF THE DISTRIBUTIONAL IMPACTS OF REGULATION AND DEREGULATION OF FINANCE IN INDONESIA: 1967-2000

You delight in laying down laws,
Yet you delight more in breaking them.
Like children playing by the ocean who build sand-towers with constancy and then destroy them with laughter.
But while you build your sand-towers the ocean brings more sand to the shore,
And when you destroy them, the ocean laughs with you.
Verily the ocean laughs always with the innocent.
-Kahlil Gibran

4.1 Introduction

Modern Indonesian economic history often starts with the arrival of General Suharto into power and the installation of the 'New Order' regime in 1965. While the era was a politically repressive one, it also brought with it three decades of stability and rapid economic growth. This remarkable achievement was to be followed by a wholly unexpected and devastating financial crisis in 1997. The steep decline in welfare, among the worst reversals in modern economic history, has meant that most current analyses of the Indonesian system are heavily focused on the multiple causes and consequences of the crisis.

Given that this ruinous change was precipitated through the East Asian financial crisis it is important to analyze the history of the regulatory financial structures in the country and the ways in which it dovetailed with national developmental goals. This narrative is, in its broadest contours, a familiar one.

Much like in the case of India examined earlier, the Indonesian financial system saw extensive state intervention during the 1970s and 1980s before a combination of factors led to the gradual dissolution of direct and indirect control in the last two decades. The particular form, pace and content of the repression and liberalization of the financial system, however, has been substantially different. Unlike in India, financial reforms in Indonesia were more spread out and more organic, in the sense that they evolved over a longer period in response to particular macroeconomic and political imperatives, as opposed to being adopted as part of an ideological u-turn away from a dirigiste regime.

Others have discussed the evolution of the Indonesian financial system in greater detail (see Cole and Slade, 1996).The focus of this chapter, however is narrower. The purpose is to describe the evolution of the financial architecture in Indonesia in order to assess how elements in the financial system allowed for policies that promoted relative equity during the process of rapid development. In addition to maintaining a rapid growth rate of about 5% a year over three decades, a remarkable characteristic of the Indonesian story is the degree to which it maintained a relatively stable income distribution as well as consistent and conscious policy of spreading the gains from growth. The chapter goes on to consider the effects of financial deregulation from the mid 1980s and the devastating financial crisis (itself a direct outcome of deregulation) on aspects of inequality within the country.

What emerges from the study is a complex picture with a guiding thread. The technocractic elite which made policy over the three decades displayed a consistent preference towards a more liberal economic regime. Despite this, as Stiglitz, 1993 among others have noted, the financial sector was actively and extensively controlled and managed to allow the gains from growth to become more widespread. With the deregulation of the sector and changes in the political

economy, the latitude given to policy makers to transfer resources as part of a developmental program has been severely curtailed.

The analysis will be divided as in the case of India into the same three conceptually distinct 'circuits' of finance: the bank based financial circuit, the government finance circuit and the market based (or capital market based) circuit. The allocation of finance in Indonesia has been dominated by the first. Interventions into the financial market by the government were more indirect than in India, shorter-lived, and did not involve capturing funds for government expenditure. The capital market has been a late entrant into the financial system and only began to develop in the early 1990s. It has not been an important source of funds for the most part, except for the post crisis period. As such, the majority of this chapter will focus on the trajectory of the banking sector.

In order to describe the co-evolution of the financial system and distributional outcomes in Indonesia, a rough but indicative description would identify three historical periods: the period of financial repression and management under Suharto from 1966 to 1983, the period of increasing liberalization from 1983 to 1997 (over two stages), and the post crisis period from 1997 to date. The salient features of each of these periods grew from the macroeconomic imperatives facing Indonesia in each, and the story is therefore less one of the replacement of one paradigm for another, than that of an organically developing, substantively planned financial system.

This chapter is laid out as follows. In the first section, the banking sector and its development during the reign of the New Order is described.During the first period, the active management of the financial sector allowed the state to direct resources towards areas (particularly agriculture) which allowed for rapid development. This was particularly important given that Indonesia had an open capital account and a limited range of options to generate domestic resources

for investment.The rapid reduction in poverty as well as a stable low level of inequality was directly assisted by such management. With macroeconomic changes in the 1980s and consequent reforms, especially after 1980, an explosion of private credit laid the groundwork for the financial crisis of 1997. Poverty and inequality rose following the crisis. The next section considers the effects of the crisis, in particular, on the fiscal capacity of the state. Given a nascent debt market, and a huge internal and external debt burden arising from the crisis, the state finds itself perilously close to being in a debt trap. It has consequently foregone much needed development and social expenditure. The penultimate section describes the concentration of financial resources seen in the burgeoning capital market which has certainly resulted in increased wealth concentration. The final section concludes.

4.2 The Banking Sector

4.2.1 1967-1983: Policy Based Finance

A central concern of the New Order regime that began under Suharto in 1966 was the reestablishment of political and macroeconomic stability following the political turmoil and hyperinflation of the last year of the Sukarno government. As has been well described in several accounts (Timmer, 2004, Temple 2001) in order to achieve this, Suharto appointed a team of economic advisers from the Faculty of Economics of the University of Indonesia. The 'Berkeley Mafia' (so called because three of the five original advisors had received their PhDs from Berkeley) were the archetypal technocrats mentioned in accounts of east asian development. They displayed a strong preference for orthodox economic policy and were insulated from public pressure in their ability to adopt it.

In order to conquer the hyperinflation and to restore credibility, Indonesia undertook strongly orthodox macroeconomic reforms. Two particular elements

testify to the surprising adherence at the very outset to principles that were later enshrined in the Washington consensus. The first was the balanced budget rule, which contained the budget deficit by decree. The government did not have recourse to deficit financing from domestic resources and thus, a deficit led inflationary spiral was made more difficult [1]. The second element was the move to an open capital account in 1971. In this regard, Indonesia is well known as defying the orthodoxy in terms of the sequencing structure of reforms. Inverting the order proposed by McKinnon (1973), Indonesia abolished controls on foreign exchange transactions first and moved, decades later, to internal reforms. The logic of the open capital account was to exert some market discipline on domestic monetary management, so that the threat of exit would effectively check inordinate monetary expansion[2].Macintyre, 2003 sees this move as the cornerstone of subsequent policy as an effective commitment device for investors.

Despite the fact that in two key areas the power of the state had been severely curtailed, it retained the capacity to affect outcomes through other means[3]. While internationally capital mobility was not restricted[4], the domestic finan-

[1]Authors such as Stern, 2003 have suggested that the presumed fiscal discipline exerted by the balanced budget rule was less stringent than might at first be evident. First, the balance was only between domestic revenues and expenditures so that any inflow of foreign aid or capital might be used to finance expenditure. Second there were widely known, but unquantified off budget accounts which were used to finance certain industries.

[2]Another less ideological and more practical reason for the adoption of an open capital account was the proximity of an open financial center in Singapore which would have made controlling capital flows very difficult in any event.

[3]One important lever was a controlled exchange rate. Although restrictions on foreign exchange transactions were limited, the ability to devalue proved to be an essential feature in Indonesia's management of the economy when faced with global shocks.

[4]This fact is perhaps sometimes overstated. As Fane, 1994 details, the Indonesian authorities often used tight domestic financial control to regulate financial flows within the economy from abroad. For example, although it was true that

cial system was decidedly illiberal during this period. Table (4.1) describes the structure of the banking system (the most important part of the financial system, since the capital market was completely underdeveloped during this time). It is evident immediately that the banking sector was dominated by the state in the form of the central bank[5] and the state banks. Between half and three fourths of total credit in the system was directly intermediated by the state financial sector. As such, the domestic banking system was perhaps the key lever for macroeconomic direction in Indonesia during the period. Apart from installing significant set of interest rate controls, there were restrictions on bank entry, directed lending requirements for banks and restrictions on bank's uses of foreign funds.

These means were heavily utilized during the initial phase to promote a genuinely developmentalist agenda: one that had a primary focus on agriculture while simultaneously attempting to industrialize an archetypal dualistic economy.

4.2.1.1 Agricultural Finance

One of the more puzzling issues for followers of Indonesian political economy is the reason why, despite the ambivalence of the technocratic elite, agrarian renewal and rural improvement was so central to Indonesian policy in this period.

Indonesian firms were able to borrow directly from overseas banks after 1970, controls were maintained on bank borrowing offshore and banks ability to borrow offshore was limited. In addition, periodic controls were placed on public sector borrowing from offshore lenders in order to prevent the debt obligation of the government from ballooning. As late as 1991 there were laws enacted in which there has been a requirement that state enterprises, and private enterprises whose projects involve linkages with state enterprises, must obtain official approval for any offshore borrowing.

[5]As much as 40 % of credit disbursed by state banks in some years was provided by the central bank (Cole and Slade, 1996).

The reasons suggested have ranged from the idea that the focus on agriculture was to ward off the threat of communist uprising (Timmer, 2004) to the idea that Suharto himself grew up in a rural setting, to the idea that the government was interested in consolidating power (Macintyre, 1993). Regardless of the motivation, it remains that the period saw agricultural development being given a central role in the government's overall strategy of development.

One of the most important agencies within the Indonesian government during the period was Bulog, the food logistics agency. In the period, it coordinated major policies for agricultural growth. Additional elements in the pro agricultural framework were major investments in irrigation rehabilitation, subsidies for inputs such as fertilizers and pesticides, stabilization of rice prices through government directed price floors, introduction of high yielding varieties of crops, investment in roads and schools, and, crucially, the extension of farm credits through the Bimas and Inmas credit programs.

Given the widespread acceptance of the centrality of agricultural policies during the 1970s it is interesting to trace out the manner in which this was undertaken as this underscores the importance of the controlled domestic financial sector as a lever of development. Table (4.2) below lists the annual government expenditure on the agricultural, forestries and fishing sector as a percentage of GDP between 1973 and 1983.

What is evident are the strikingly small outlays on the sector. An important reason for this was undoubtedly the limitations imposed by the balanced budget decree but perhaps also a distrust among the technocrats of direct government spending. It was in this context of limited potential direct public investment that the credit allocation program took on such importance. Table (4.3), drawn from Macintyre, 1993 and the Bank Indonesia's financial statistics, lists the subsidized credits going to the agricultural sector as a percentage of total bank credit. In

the first decade, a fifth of all bank credit was directed towards the agricultural sector either through food stabilization or through various credit schemes[6].As is evident with comparison to table (4.2), credit to the sector matched or exceeded direct government spending on it during the initial decade and a half of the Suharto era.

Interest rates in the rice sector in particular and in the agricultural sector in general were set at very low levels, resulting in negative real interest rates in the economy for a whole for considerable periods of time during the 1970s (Figure 4.1). At the same time, in order to maintain financial stability, the government set deposit interest rates at relatively high levels. The difference between the low lending rates and the high deposit rates were covered by the windfall gains from the oil revenue earned with the oil price boom in the early 1970s. There is little argument that despite the potential for rent seeking, the financial intermediation process was effective during its first years for the rural sector. When there was evidence of misappropriation of credit by large farmers, the government switched from the Bimas program to a more flexible system of credits called Inmas in 1977.

Two structural features also enhanced the effect of the policy. The first was the existence of the well established 'Unit Desa' of the Bank Raykat Indonesia (BRI). These remain the premier mode of rural finance in Indonesia, currently serving over two and a half million accounts all over the archipelago. Set up in colonial times, the bank saw a rapid increase in the number of units -'Unit Desa' during the period. Although the restrictions on lending interest rates meant that there were significant losses, the geographically widespread financial

[6]This figure would doubtless be higher, but for the fact of the failing of Indonesia's largest oil producing firm Pertamina, in 1975. The bailout was financed by the banking sector, and the cost between 1975 and 1980 averaged about a third of all bank lending.

outlets allowed for an easier disbursement of directed credit. This is particularly important in a country like Indonesia, where spatially determined inequality is a central issue (cf. Islam, 2003). The second feature, identified (albeit indirectly) by Afiff and Timmer,1971 were the land reforms undertaken by the Sukarno regime earlier. The median land holding in Indonesia during the 1970s was less than a hectare, the impact of the rice intensification and the farmer credit program was widespread.

A significant feature during the period was the consistency shown in the supporting macroeconomic policies. Perhaps the most important in this regard was the willingness of the government to use exchange rate policies as a strategic tool. This was particularly important during the oil boom of the 1970s. Warr, 1984 notes that Indonesia began to feel the effects of "Dutch Disease" in the mid 1970s with a decrease in the profitability of tradeables, especially in the agricultural sector. The response of the government was to undertake a quick devaluation, an action which revived growth in the rural sector and in the urban tradeables sector. Another interesting instance of the subordination of exchange rate policy to the overall policy of rural development. When Indonesia was faced with an agricultural depression due to collapsing world prices in 1983, for example, this was resolved by a sharp devaluation[7].

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[7]Timmer, 2004 describes an interesting natural experiment in which Indonesia and Thailand undertook different strategies to deal with the same collapse in world prices. While Indonesia devalued in order to maintain its export markets,Thailand did not. The result was that while Thailand grew faster, the bottom twenty percent of the population (primarily agrarian in both countries) were twenty five percent wealthier in Indonesia than in Thailand by the end of the decade. The relatively more equal distribution of income in Indonesia from 1980-2000 is certainly in part due to the unwillingness of the Indonesian authorities to abandon the agricultural sector.

As these episodes show, while the oil boom was the central event that allowed for a prolonged period of subsidized credit, it also required close management. Fresh in the Indonesian memory of the 1970s would have been the hyperinflation of the late Sukarno period. In this context, the inflationary pressures arising from both the balance of payments surplus and, more crucially, increasing oil revenues from the OPEC crisis were a pressing concern. Once again, the financial system was used to check this.A Ceiling on expansion of bank credit played a critical role is ensuring that liquidity kept apace with the absorptive capacity of the economy[8].Banks were subject to strict lending restrictions which were determined by past performance. The allocation of credits for development purposes followed automatically and was implemented through the state owned banks.The fact that the financial depth of the system did not increase over the 1970s was then a result of both repressed interest rates and the stringent controls put on lending by the government (itself a response to the oil boom).

Another often overlooked reason for the slow growth rate in financial depth was paradoxically, the open capital account. The repressed interest rate regime is something of a mystery given the fact that such lending rates would have been very attractive to offshore borrowers who faced higher rates, and as such, there would have been an excess demand for Indonesian funds. Goeltom , 1995 suggests that one reason why the authorities prevented lending growth was to prevent capital exodus because of this interest rate differential.

Table (4.4) illustrates the slow growth of the money supply by listing the ratio of M2 to GDP in Indonesia during the period.

While these levels were slow to grow, the directed credit programs ensured that in the key sector of agriculture, adequate finance was maintained for growth

[8]It is interesting to note that this initiative was proposed and supported by the International Monetary Fund.

and poverty reduction. At the same time, the public sector was able to obtain funding from oil revenues and other directed credit allocation programs, while large corporations borrowed freely from abroad because of the open capital account. The one sector then which could be said to have been rationed out of the financial system was the small scale industrial sector.

4.2.1.2 Small and Medium Enterprises

If there was a failure in the use of credit allocation as a tool of development then, it was in this area. Because domestic savings in the formal sector was limited both by the level of development and inadequate financial depth, the government undertook to supplement their employment generation policies by providing subsidized credit to the small scale industrial sector. The most significant scheme introduced was the KIK/KMKP scheme which provided working and investment capital to the local (pribumi) small firms. What is immediately evident from Table (4.5) is that the scale of subsidized credit to small scale industry was much smaller than for agriculture. The total credit allocation towards these activities never exceeded more than 5% of bank credit during the period and beyond[9]. In addition, in comparison to the effectiveness of credit allocation to agricultural activities, observers of the financial system in Indonesia view the experiment with directed credit to small scale industry to be a failure. Most studies blame this on the interference with the price mechanism and competition, since the direction of credit to less efficient ethnically local firms (as opposed to firms owned by ethnic Chinese in Indonesia) meant that credit was not effectively used to enhance productivity. In addition, corruption became pervasive in allocating loans to small firms. The sum total of these problems was a growing number of non performing assets in bank portfolios over the pe-

[9]The program extended to 1990.

riod, and no significant growth in the SME sector. For the first decade and a half though, public sector growth and agricultural growth ensured continuing employment generation.

4.2.1.3 Poverty and Inequality

Despite the problems in the small to medium enterprises sector, much evidence suggests that this period saw the most rapid advances in poverty reduction in the last four decades in Indonesia. While there were no systematic surveys undertaken before the first national SUSENAS survey of 1976, poverty has been estimated to be as high as 60% -70% at the beginning of the 1970s. The period also saw the most rapid, sectorally widespread growth in Indonesia's modern history with an average annual growth rate of over 7 percent. Table (4.6) and (4.7) point to the importance of this period in terms of its impact on poverty and distribution.

Poverty in both urban and rural Indonesia fell most sharply between 1976 and 1984, leading to halving of poverty incidence during the period. Similarly, measures of inequality were stable and the relative share of the bottom 20% versus the top 20% was equally so. The one anomalous year is 1978, where the oil boom generated "Dutch Disease" effect induced a shift away from labor intensive activities -both in the urban and rural sectors- to the non traded goods sector, leading to increased urban and rural inequality. The devaluation of 1978 was adequate to redress the situation.

Rapid agricultural growth from the 1970s to the 1990s was the crux of these achievements[10].It would certainly be wrong to credit this success solely to the

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[10]The sector grew at an average of 3.5% from 1970-1985 and this growth has proved to be crucial. Sumarto and Suryhadi, 2003use a growth decomposition regression to show that agricultural growth is the only sectoral growth component to display a significant negative effect on the poverty headcount ratio in

financial policies undertaken by the government of Indonesia; the introduction of high yield variety technology, the technological diversification of production toward non-rice food crops and nonfood farm activities, increased public investment, and oil revenues all contributed. Nevertheless, the subordination of the financial sector for a definite purpose- the promotion of pro poor agricultural led development- and the adoption of supporting macroeconomic policies was central to the achievement, especially because the government was constrained both in respect to its fiscal policy (because of the balanced budget decree) and its monetary policy (because of the open capital account). If nothing else, the era shows that a planned and egalitarian transition from a primarily agrarian economy to an industrial economy could be undertaken in a short time even with significant constraints, if the political system is willing to commandeer the resources of the financial system to this end and to maintain other supporting policies. The gain in terms of growth with widespread benefits is significant. As Timmer, 2004 summarizes the matter:

> ..[T]he attention to continued growth in agriculture in Indonesia translated into one of the most pro-poor growth episodes in modern development experience
> Timmer, 2004.

This period of policy based finance, as it is sometimes called, began to face pressures which led ultimately to financial reforms. Most significantly, the preferential credit system was predicated upon large oil revenues to make up the difference between lending and deposit interest rates, as well as to provide loans for subsidized credit. Furthermore, because interest rates were negative for long periods of time, the rural financial system did not generate increased savings,

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Indonesia over the last 30 years. Relatedly, Asra, 2000 finds that the continued decline in rural poverty in the 1980s was the most important cause of declining overall poverty in Indonesia in the decade.

and the financial depth of the system as measured by the ratio of broad money to GDP remained stagnant through the 1970s. As such, it was difficult to mobilize resources. The end of the oil boom in 1983 and the growing worry about non performing assets (especially from the small scale industrial sector) signaled the unsustainability of the regime and a need for a change of direction. Moreover, with self sufficiency in rice production around the corner and a larger urban population, the time was ripe to shift towards garnering more domestic resources and encouraging industrial development. The financial reforms of 1983 announced this reorientation.

4.2.2 1983-1997: Financial Liberalization

Faced with declining oil revenues and a deteriorating balance of payments in early 1982, the government of Indonesia began a process towards greater market orientation.

While there were substantial changes in the real side of the economy in terms of privatization, liberalization, and trade reform, the financial system was deregulated in two stages. The first stage, which was undertaken in 1983 before the collapse in oil prices, involved the abolition of most bank lending controls, and the abolition of ceilings on deposit rates at state banks. The second stage of reforms called the PAKTO package, began in 1988 with changes in controls to bank borrowing and lending rates, and a relaxation of banking entry norms. Controls on foreign and domestic investment in Indonesian manufacturing were also progressively relaxed from October 1986. Table (4.8) below lists the major changes in banking component of the two programs.

Many commentators who were sympathetic to the liberal regime have focused on the financial deregulation as the fulcrum in the favorable growth experience

of the 1980s/early 1990s[11]. Such analyses invariably omit to mention both the gradual nature of liberalization (seen by the decade long process) as well as the continued intervention in financial markets by the authorities in crucial areas, especially during the early transitional years.

Many elements in the reform process point to this. First, the subsidized agricultural credits under the Bimas program were left untouched during the 1983 banking act. As such, subsidized credit to the agricultural sector continued well into the late 1980s. Just as important for the rural sector were the new programs initiated by the BRI. Because of the insistence on the establishment of geographically widespread financial outlets under the Bimas program, by 1983, over 3500 units were spread around the country. Instead of folding up these outlets as a part of liberalization, the state launched new programs. The simpedes and kupedes programs were commercial loan products which are targeted at low income borrowers, but with generous and flexible terms of repayment. The kut program continued to provide subsidized credit, although this was scaled back in terms of access. The positive but low real interest rates that came about helped to increase the financial depth of the system, and to generate a massive increase in savings. As a result, the BRI began to generate profits and the rural credit delivery system became both larger and healthier, and ultimately, by 1990, self sufficient. Were it not for these programs, it is entirely possible that the strides that were made in terms of reducing rural poverty in the 1970s would have been lost or dissipated. Instead, rural growth remained fairly robust through the 1980s, and poverty reduction continued.

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[11]For example McLeod, 1994, pp 18 writes: "The combination of the June '83 and October '88 packages took Indonesia's banking system in just five years from state bank dominance and bureaucratic suffocation to being an effervescent, private sector-driven collection of institutions, remarkably free of government intervention"

Despite the freeing of deposit and lending interest rates, state banks, which accounted for the largest proportion of the financial assets of the country, consistently maintained lending interest rates that were three to four percentage points lower than that of private banks(although all interest rates were higher). State banks were seen to be agents of development and not business ventures, and as such, were expected to maintain lower rates for constrained borrowers. Bank Indonesia continued to provide loans to public banks in order to do this for both important urban and rural priorities.

Nor was directed credit towards priority sectors such as small to medium enterprises and the export sector done away with completely. In the initial years following the 1983 reforms, all banks were required to allocate 20% of their total loans to small and medium enterprises, while offshore banks were required to allocate half of their loans to export activities (Cole and Slade, 1996, pp 90). The sum effect of these few but well targeted schemes was that vulnerable sectors did not face immediate financial disintermediation.

Perhaps the most significant effect in terms of the financial architecture of Indonesia during this period was the emergence of a much larger private banking presence. With no interest rate restrictions and the ability to obtain positive interest rates, there was an influx of capital into the financial system (as might have been predicted from a McKinnon and Shaw view), increasingly towards the private banking sector. While the McKinnon and Shaw perspective expected this to occur because of a shift of funds from the informal to the formal sector, in the Indonesian case, this occurred because of the return of funds from abroad. By any measure, however, there was a rapid deepening of the financial system. With the 1988 PAKTO reforms which eased restrictions on private bank openings, there was an explosion in the number of banks from 111 in 1988 to around 240

by 1997[12] . Figure 4.2, derived from Hamada, 2003, shows that between 1983 and 1997, private and foreign owned banks grew from owning less than a fifth of all banking assets to more than 50%, while public banks saw a decline in their share of assets from over 70% to about 45% during the period. Private banks moved from providing 25% of credit to 50% of credit while foreign banks tripled their share from 3% of all credit advanced to 10%.

4.2.2.1 Managing Financial Repression and Liberalization

It is clear from the description above that the state banking sector behaved more like a developmental finance institution than a typical bank (state or private) during the pre liberalization period and the early parts of the period of liberalization. State bank lending fulfilled government mandated and subsidized programs designed to promote various economic activities, including state enterprises and small-scale pribumi businesses. Bank Indonesia underwrote such lending through subsidized credit. Given the extremely complex system of credit allocation, and (at least theoretically) large opportunities for arbitrage, the relative success and stability of the directed credit programs needs some explaining.[13]. Several factors were important, including the historical role of state

[12]As a consequence, competitive pressures began to face all banks. A direct result- especially in the 1990s- was riskier lending, a practice which greatly exacerbated the financial crisis (see the section on the period following 1997).

[13]The system was certainly not free of inefficiencies and corruption. By the 1980s it became clear that much credit was allocated on the basis of reputation rather than merit (Cole and Slade, 1996, page 86) and that the ethnic Chinese were particularly favored. Nevertheless, it is difficult to contest the fact that a vast amount of credit did flow for nearly a decade to useful and productive projects. Equally, corruption in credit allocation was just as evident, if not more, in the period of deregulation, in which private banks and state banks both directed funds towards the firms which were controlled by the political elite.

banks, considerably skilled and forceful technocratic control, and the availability of access to funds from abroad for larger firms.

For the most part, the private banking sector in Indonesia was under the defacto control of the central bank. An extensive set of licensing restrictions and credit quotas bound their lending opportunities so that in 1983, they represented only a quarter of all commercial bank lending, despite offering superior deposit and lending rates. There was a very clear oversight of the private banking sector undertaken by the central bank. By most accounts (cf.Macintyre, 1991, Cole and Slade, 1996), technocratic direction of the central bank ensured that its oversight duties were not heavily compromised and that state banks did not- for the most part- cross-subsidize private loans.

Just as importantly,although they did offer superior interest rates, private banks were not perceived as being as safe as public sector banks. Thus,the latter were able to offer lower deposit rates in their capacity as 'agents of development', and through their extensive branching network were still able to generate much larger deposit bases.

Finally, the open capital account meant that larger firms which did not receive preferential credit were not credit constrained. Indeed, they commonly borrowed from markets abroad and as such freed domestic credit for directed allocation.

Paradoxically, the liberalization of the financial regime was more poorly managed, as the next sections detail.

4.2.2.2 Effects of Second Generation Reforms

It was only in the late 1980s and early 1990s- after the second generation of reforms- that the changes wrought began to truly take effect. A period of high growth and abundant liquidity in the system, combined with a much more

liberal financial architecture than before meant that the financial structure and financing patterns began to change rapidly.

The growth rate of the financial system in the early 1990s was rapid. Table (4.9) below gives the growth rate of M1 and of the various components of bank credit. As is evident, while there was rapid growth in bank credit through this period, it was in the newly liberalized private bank sector and foreign bank sectors that this expansion was the greatest. The anomalous growth seen in 1992 was due to the temporary tightening of monetary policy and the adoption of stiff prudential regulations[14] in response to concerns about accelerating inflation.

It is certainly clear that the liberalization of banks and the rapid growth of the early nineties set the stage for the weaknesses that would be exposed during the Asian financial crisis. The story is well known. Private banks and foreign banks began to shift their portfolios towards ambitious infrastructure (typically real estate) projects often closely associated with political figures[15] ,and away from manufacturing, trade and agriculture as shown in Figure 4.3.

At the same time, there was a massive inflow of private capital between 1990 and 1995, with annual capital flows in 1995 and 1996 exceeding 10 billion dollars a year (from an average of 2.5 billion dollars a year between 1985 and 1990). Some of this capital was channeled through the foreign and private banks. Just as importantly, these funds were short term, and denominated in foreign currency, while private banks tended to lend long, thereby creating a term mismatch.

[14]These were later to be lifted since they were condemned as being too burdensome to banks.

[15]In this there is a certain irony. One of the more compelling reasons provided for the liberalization of financial market is the notion that in a repressed financial market, it is easy for credit to be hijacked by political imperatives, nepotism and outright cronyism as credit is diverted towards the politically powerful. The experience of the 1990s suggests that private markets can achieve this maldistribution at least as effectively as a controlled one.

Foreign debt held by the banking sector, while important for their balance sheets and the health of the banking system in general, was only a small amount of total foreign debt held by the system. A much larger proportion was held in corporate debt. In 1997, the Thai Baht's external value collapsed. With the contagion effects that swept through East Asia, speculative worries resulted in a massive exodus of capital from the corporate and banking sectors in Indonesia. This led to a sharp increase in banking distress, and eventually a full blown currency crisis.

4.2.2.3 Poverty and Inequality

The rapid urban growth of the early 1990s, assisted by easy credit availability with deregulation and rapid growth in private banking activity had important distributional consequences. It is difficult to gauge the exact reduction in the poverty headcount ratio between 1990 and 1996, because of a change in the methodology adopted by Susenas in 1996 (see table 4.5). It is generally accepted, however, that there was a significant reduction in dire poverty.[16]

At the same time, this period saw a rapid deterioration in the distribution of income, driven by both a shift in rural-urban disparities and a sharp increase in urban inequality (Table (4.10)). Labor force estimates from BPS suggest that there was large scale rural-urban migration in this period as employment in the urban sector began to grow rapidly while employment in the rural sector declined at an average of 0.5% a year. Akita, 2002 estimates that much of the increase in inequality between 1990 and 1993 was due to the this process. Much of the rise in urban inequality appears to have been caused by an increase

[16]What are unclear are the effects on the number of people just above the poverty line. The Asian Development bank (ADB, 2000) report on poverty in Asia estimates that over half the population still remains just above the poverty line.

in upper incomes, rather than a deterioration in lower incomes (Kadarmanto and Kamiya, 2002). There were however, fewer employment opportunities for the unskilled. For those with primary education or less, there was an average annual decline of 0.2% in employment, while for those with secondary education or higher, there was an average annual increase of over 10% . This said, there was solid growth in wages (5% per annum) for less educated workers who were employed.[17]

The period 1987-1996 was therefore a period of both reduction in poverty and increased inequality. It is difficult to conceive of direct causal linkages between financial liberalization and these outcomes, not least because the proximate reasons behind these changes are not well understood. At the broadest level, however, the changes in the financial system were organically linked to a change in the pattern of growth in the late 1980s and early 1990s. In the new regime, rapid urban growth (financed by abundant credit) changed employment patterns by moving people from unpaid family labor and the agricultural sector towards urban centers and cities. At the same time, as the pattern of growth moved away from sectors which had provided employment for low skilled workers (agriculture, manufacturing and trade) and towards (unsustainably) the non traded and infrastructural sectors. Lending followed these trends as well. Of more important consequence for considerations of poverty and income distribution, however, was the way in which the deregulated system led to the Asian financial crisis and the aftermath.

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[17]This is therefore a variation from the finding of Behrman et al, 2000 who found that financial and capital account deregulation was associated with a rise in the wage gap between low and high educated workers in a cross country study of Latin America. In the Indonesian case, rather than relatively low wages, there was less employment for those who lacked education.

4.2.3 1997-2005: Crisis and After

Even in early 1997, the Indonesian crisis was unexpected. According to Furman and Stiglitz, 1998 Indonesia was the least likely of 38 countries in which exchange rate crises occurred- to experience one based on its macroeconomic indicators. While some ex-post explanations focus on weaknesses in the prudential banking regulations and cronyism as key institutional failures, others also point to the fundamental powerlessness of authorities to stem panic and overreaction in a completely deregulated financial system. In Indonesia's case, the last vestige of control was the fixed exchange rate. Nasution, 1998 summarizes the immediate consequences of its deregulation.

> On August 14, 1997 Bank Indonesia, abandoned its exchange rate intervention band and moved to a floating exchange rate system. From June to December 1997, the rupiah depreciated by over 50 percent against the US dollar, interest rates soared to over 30 percent per annum, and the Jakarta Stock Exchange plunged by about 50 percent. Capital outflows continued to accelerate in spite of the IMF standby Arrangements, high interest rates on Indonesian securities, rupiah depreciation, and financial indicators that pointed to long-term solvency.

If there was any period in which the open capital account severely hurt the economy, it was during this episode. With an open capital account and accelerating capital flight, the authorities could only raise rates on their securities in order to assuage the markets. The move did not work, and only succeeded in increasing the foreign debt burden of the country. Equally, the open capital account precipitated and exacerbated a nosedive in the fortunes of the banking sector.

One consequence of financial deregulation, as mentioned above, was the vast increase in entry and competition in the banking sector. There was a significant reduction in interest spreads and much lower margins for banks. Given the pressure on profits, the lack of oversight and the rapid growth being experienced,

banks took to servicing several risky loans. Investment in the stock market and the real estate sector was symptomatic of these pressures. The vast inflows of capital in 1995 and 1996 had led to rapidly rising equity and property prices and increased banking credit to these sectors. The Jakarta Stock Exchange rose and urban land prices rose sharply during the same period. It was no surprise then, with capital flight and a plummeting of equity and real estate prices, there was a sudden increase in unrecoverable loans and in banking distress in general.

The government had not been entirely somnolent during the boom, but had been constrained in their ability to regulate finance. With respect to the state's own accounts, the government instituted quantitative ceilings on offshore borrowing for the public sector and attempted to retire debt by privatization proceeds. They maintained strict budget discipline (running a surplus on the fiscal balance from 1993-1996) and raised reserve requirements. Yet, in terms of the private sector, the authorities only really attempted moral suasion, and that too only in 1997 when they asked commercial banks to slow lending to the real estate sector. By this time, it was too late to prevent the bubble from bursting.

In late 1997, under an IMF led rescue package, the government closed down sixteen insolvent banks and raised interest rates once again. Rather then restoring confidence, these measures only served to exacerbate nervousness and precipitate a full scale bank run, amidst rumors of the government's imminent fall. To compound matters, the corporate sector's debt denominated in foreign currency had become unserviceable as the Rupiah went into free fall, declining by 80% in a year. There were major defaults on loans which deepened the banking crisis. The currency continued to depreciate as 13 billion dollars left the country between 1998 and 2000.

By early 1998, the exposure of banks to external debt and to non performing domestic loans had led to widespread distress in banking and several closures.

The economy experienced a sharp drop in GDP, initially widespread open unemployment followed by a reversal of rural-urban migration as the agricultural sector acted as a last safety net absorbing millions of displaced workers. To make matters worse, weather patterns ensured poor harvests, worsening the effects in the rural areas. The crisis in the real sector meant that there was a major contraction in lending in the late 1990s. Table (4.11) below summarizes some of the macroeconomic changes that occurred during the period.

As such, there were four central and interlinked macroeconomic reasons for the severity of the crisis: the El Nino drought, the real devaluation, the domestic credit crunch and the foreign credit crunch[18] . Unsurprisingly, poverty incidence registered a sharp increase following the crisis (see table (4.5)). The gini coefficient meanwhile decreased (see table(4.10)).

Several studies examine the manner in which poverty and inequality evolved over the period, and it is only possible here to briefly summarize their main findings.

The immediate effect of the crisis was to increase unemployment and a flight to the informal sector and agriculture (especially for women). At the same time, there was a substantial decline in real wages. Table (4.12) describes these changes between 1997 and 1998. In terms of wage income distribution, the crisis was an equal opportunity calamity. Smith et al., 2002 find that wages fell by roughly the same proportion at all centiles of the wage distribution (Table 4.13). Initially, this fact and the reduction in the gini coefficient was believed to be evidence that the crisis was primarily an urban phenomenon and limited to the middle and upper classes. Recent work, for example by Friedman and Levinsohn,

[18]While it is difficult to separate the impact of each effect easily, Bourguignon et al, 2002 use a CGE calibrated microsimulation to suggest that the major impacts on poverty were felt through the financial market credit crunch and the devaluation.

2001, shows that in fact it was the urban poor who were the worst hit during the crisis[19].Other supporting evidence for this finding is compelling. Inequality within the capital of Djakarta rose by a full ten points from 0.36 in 1996 to 0.46 in 1999 (IBRD, 2003) and inequality among the poor rose as well.

The decline in the overall gini coefficient from 0.36 to 0.33 between 1997 and 2002 can therefore be explained mostly by the reversal in rural-urban migration. However, the vast amount of capital flight from the economy which took place during this period makes comparisons over the period difficult. Kadarmanto and Kamiya, 2002, suggest that much of this capital flight was from the top income households, (especially the externally connected ethnic Chinese). Furthermore, given the currency depreciation, the value, in domestic terms, of this flight capital has increased vastly. As such, the gini coefficient (already unable to take into account high income bias), is probably severely biased downwards since upper income households own more higher valued, foreign currency denominated assets which may not be declared.

Because of the wide-ranging consequences, restructuring the financial system has become perhaps the central concern of policy makers of the post Suharto era. The recapitalization process has meant that banks have become essentially nationalized, and that public funds have come to the rescue-through recapitalization bonds- of private excesses. It is an element of the package which Bello, 1998 calls "socialism for the global financial elite." Table (4.14) depicts this process. To make matters worse, it is now widely accepted that the bailout package of 1997-1999 was further compromised by corruption. Lim et al, 2004 cite an audit which suggests that as much as 60% of the 13-16 billion dollars pumped by Bank

[19]The ability of the rural poor to turn to subsistence food production meant that the effects were somewhat less on them.

Indonesia into the banking system had been misused or misallocated[20]. As such, public money has bolstered the incomes of the rich. At the same time, the heavy debt burden incurred by the vast funds locked in recapitalization bonds has had detrimental effects on the poor by halting the expansion of the economy and putting pressure on public (and private) investment. These consequences will be dealt with in detail in the following section.

To summarize, the history of the Indonesian banking sector provides strong evidence of the power of financial liberalization and financial instability to overturn a broad based and relatively successful developmentalist paradigm. Despite a general preference among policy markets for allowing markets to decide allocative outcomes, the pro-poor expansion of the 1970s and 1980s may not have occurred without denying the impulse to liberalize and using the domestic financial system as a tool of development. No one would argue that Indonesia was free of other problems: certainly extraordinary cronyism and corruption existed which contributed to the financial crisis. Indeed, some (for e.g. Cole and Slade, 1998) believe the crisis to be caused primarily by governance issues. However, the deregulation of the financial system acted as the trigger, or tipping point which undid the self-same regime that delivered stable, egalitarian growth for thirty years. That is, it is conceivable and even likely that without the financial crisis, Indonesia's technocratic elite may still have been guiding allocation and development policy in a dirigiste manner today, despite widespread corruption and misgovernance. With the financial crisis this became impossible.

The resource transfers that were central to the rapid reduction of poverty during the first two decades of the New Order government and which were made possible through directed credit mechanisms and intelligent regulations are dif-

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[20]Equally important, as shall be discussed in the section on government finance, the bailout meant that these funds were lost to the government.

ficult to replicate at the current juncture. The resolution of the financial crisis and the reconfiguration of the banking system have demanded much of the resources of the government. Specifically, an explosion in the level of public debt has meant that fiscal policy as a rescue measure has been severely curtailed and that the country has fallen into an old fashioned debt-trap. As a result, poverty reduction and egalitarian growth have had to take the back seat for now. It is to the implications of financial liberalization for fiscal policy that we now turn.

4.3 Fiscal Effects of Liberalization

The notion that financial liberalization can affect distributional outcomes by changing the priorities of the state away from a developmentalist role to that of a guarantor of international investor confidence is strongly substantiated by the experience of Indonesia in the late 1990s.

It is true that the fiscal structure in Indonesia was somewhat unusual to begin with. The balanced budget decree instituted very early during the Suharto period meant that fiscal policy was heavily dependent on oil revenues and aid. The balanced budget decree did not mean that direct national revenues from taxes and borrowing needed to equal expenditures, but rather that all revenues, including foreign aid and oil revenues needed to be balanced against all expenditure. As such, foreign aid made up the difference between revenues and expenditures on the more narrowly defined fiscal balance. Two direct consequences followed. First, the government limited the fiscal deficit over the period, and second Indonesia did not really develop a real domestic debt market to speak of. Debt acquired by the government was therefore primarily foreign debt. Table (4.15) gives an indication of the trajectory of government debt profile over the three decades. The initial period of financial repression saw a decrease in government debt, as interest rates were low and the government earned substantial revenues

from oil and from foreign aid (alone averaging around 4% of GDP per year over the 1970s). In 1980, government revenues from the oil industry accounted for 70 percent of total revenues). Starting in 1982, with a higher real interest rate regime following financial liberalization, government debt began to expand, reaching a peak of over 50% of GDP in 1988. Thereafter, with decreasing interest rates, government debt began to fall until 1997, when, following the crisis, public debt rose to over 70% of GDP.

Despite the relatively high levels of debt in the pre crisis period as well, there is little evidence of interest payments crowding out of development or capital expenditure during the time. Abundant oil revenues in the 1970s and a greater tax effort in the 1980s meant that government spending on sectors which supported the poor did not fall away. Figure (4.4) below depicts the evolution of development expenditure[21]as a percentage of GDP and interest payments as a percentage of GDP over the pre and post crisis periods respectively. The figure suggests that while there is no obvious relationship between interest payments and development expenditure in the first period, in the second, in the post crisis period, the series move inversely. In order to test this conjecture somewhat more rigorously I undertake two simple OLS regressions of development expenditures/GDP on tax revenue/GDP and interest payment/GDP and a time trend for the two periods. The results are given in table (4.16) Strikingly, in the first period, interest payments did not have a significant negative effect on the ability of government to undertake development expenditure. In the second, the constraint on expenditures from having to absorb private debt and pay down public debt is apparent. The coefficients suggest that a 1% increase in the in-

[21]The figures are from the IMF governmental finance statistics for the first panel and the world bank website on Indonesian data and statistics for the second. Development expenditure is defined as the sum of expenditure on Education, Health, Transport, Mining, Agriculture and Defense.

terest payments to GDP ratio is associated with a 0.5% decrease in the ratio of development expenditures to GDP.

An important reason for the increase in the interest burden was the fact that the banking structure reestablishment required the launching of the massive recapitalization scheme, whereby the government issued Rp.410 trillion worth of bonds through the Indonesian Bank Restructuring Agency (IBRA). The story of the nationalization of private debt is a familiar one in financial crises and certainly not confined to developing countries. The increased burden of domestic debt on the public account is depicted below in Table (4.17). The banking crisis occurred as a direct consequence of financial deregulation and inadequate regulation. By early 2001, the government was paying interest worth over 4% of GNP (twice its own payment on foreign debt) annually for the policy.

Another reason why development spending has declined has been the urgent need for subsidies[22] in the aftermath of the crisis. Subsidies as a percentage of GDP rose from nearly zero in 1997 to 6% of GDP by 2000 (World Bank, 2001). Of these, rice subsidies and were deployed extensively to reduce poverty, covering almost 10 million households. These policies certainly had a major effect in improving food security as the poverty headcount was cut in half between 1999 and 2000[23]. They also reduced what could have been an explosion in inequality in Indonesia. This said, the World Bank, 2001 also estimates that the subsidies program was the least effective of the three broad post crisis initiatives (subsidies, bank restructuring and social safety net program) in reaching the

[22]Adding subsidies to the regressions, however, does not change any of the substantive conclusions, or indeed the size of the coefficients.

[23]Fuel subsidies, another major undertaking of the government, were less well targeted. Sudjana and Mishra, 2004 suggest that they benefited the middle and upper income brackets the most, as these groups were most likely to use the products.

bottom 20% of the income distribution. Nevertheless, given the popularity of and need for (at least some) of these subsidies, they have been politically difficult to withdraw. In the absence of a large domestic government debt market which could have facilitated long term borrowing and the requirement for balanced budgets, development spending has been the one expenditure item which the government has been able to cut.

To recapitulate, financial deregulation and the crisis of 1997 have combined to seriously reduce the flexibility and capacity of the government of Indonesia to pursue policies that have broad benefits. Multiple imperatives compete for the attention of policy makers. They must attempt to bolster shaky international investor confidence (backed by the exit option of an open capital account), restructure the financial system by absorbing bad private debt, pay down public debt, maintain subsidies in the face of tremendous insecurity for the majority of Indonesia's poor and spend on development objectives, all the while with a fiscal constraint partly self imposed, but partly imposed by multilateral organizations. All this is being done at the same time as an ambitious fiscal decentralization program that further reduces the capacity of the central government. While many of these problems are those facing any developing country, it is particularly galling for Indonesia that it has found itself in a debt trap brought about by financial liberalization and policy advice (in particular the high interest rate regimen advised by the IMF). While vast sums are pledged to keep the bond market stable, development spending that is fundamentally pro poor has had to fall away. Nor is this pattern likely to subside. Unless foreign debt relief is pushed, there is every potential for a vicious cycle whereby increased government debt will continue to push up market interest rates and worsen the long term stability of the government's finances. Given that much of the bank recapitaliza-

tion bonds will mature between 2004 and 2009, the distributional consequences will take some time to play out.

Rao and Khattry, 2004 make a detailed analysis of the fiscal situation in Indonesia, looking at both the inter province and national levels. They suggest several measures whereby the fiscal burden facing the government may be eased. Some of these bear mentioning as potential policy prescriptions. Three potentially fruitful ways suggest themselves: raising revenue through tax mechanisms by increasing trade and property taxes [24], monetizing the deficit (which they argue is unlikely to cause inflation, and requesting debt relief. If Indonesia is to keep from losing out on pro poor investment, at least some of these policies will need to be implemented.

4.4 Capital Market Liberalization and Distribution

The capital market in Indonesia was not an active part of the financial system until the late 1980s when reforms revitalized the sector. Several factors contributed to the tardiness of the development of the market. On the demand side, the open capital account meant that investors had access to several well developed offshore markets. At the same time, there were stringent rules which restricted foreign ownership of domestic equity. On the supply side, the public sector had abundant finance coming from oil revenue, while firms benefited from credit at subsidized interest rates; and as such, there was no incentive or necessity to issue equity. Similarly, corporate bond markets were slow to develop as firms found it easier to obtain credit from the banking sector. Cole and Slade, 1996 (pp 161-168) also point to a general diffidence among policy makers to develop a market in which expertise were lacking.

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[24]One additional possible mechanism, not considered by Rao and Khattry is to implement a transactions tax.

The sluggish growth in the capital market was changed by the financial liberalization packages of the late 1980s and direct support for the emergence of a capital market. The capital market was deregulated in three stages. The Pakdes program of 1988 relaxed government intervention, allowed stock prices to move freely, developed over the counter measures and liberalized entry for foreigners. In later stages, institutional reforms and new stock exchanges were developed. At the outset, the stock exchange was subsidized by the government, and foreign interest was generated by developing country funds which bought stocks of domestic firms. Foreign (particularly Japanese) capital began to enter the nascent stock market. At the same time, the reductions in subsidized credit and falling oil prices meant that firms were beginning to seek alternative sources of finance. The market developed rapidly as firms began to undertake bond and equity issues. Table(4.18) summarizes the changes from 1987-1994.

Table (4.19) below depicts the development of the stock market from its inception in 1977. What is immediately evident is the sharp surge in stock market activity from 1989 onwards. Between 1982 and 1988, the annual value of traded shares increased three times (from 12 to 30 billion rupiahs). From 1988 to 1997, by contrast, it increased over 4000 times to over 100000 billion Rupiahs worth of annual traded shares, a level it has more or less maintained since then.

Given the late development of the stock market its importance as a source of funds grew slowly. Figure 4.4 shows the ratio of bond and share issues to bank loans from 1991 to 2001. The ratio grew slowly up to the crisis to 20% in 1996. After the crisis the ratio shot up to nearly 80%, both because of changes in the numerator and denominator. With the acute banking crisis and the subsequent contraction in banking loans, banking sector finance reduced. At the same time, more companies, wary of extending corporate debt, began to issue equity.

Evidence on stock ownership in Indonesia is hard to come by. There have been no surveys of stock ownership and disclosure norms are less developed. Some guarded comments about the distributional consequences of the liberalization of the capital market can however be made from the limited data.

For the most part, the stock market was dominated in its early years by foreign investors who accounted for over half the transactions conducted in the Jakarta stock exchange till 1996 (Rosul, 2003). In this period, stock prices rose rapidly, with the composite share price index more than doubling over the period 1991 to 1996, before experiencing a sharp drop in the wake of the crisis. Stock prices dropped by 40% before posting a short lived recovery in 1999. Domestic investors who had been unnerved by a short stock market dip in the early nineties only began to return to equity in the boom period beginning in 1993-1994. By this time, domestic investors held the majority of shares. As such, it was foreign investors who probably benefited most from capital gains and the most from the run up in stock indices, gaining from the early boom and relinquishing their positions before the worst of the crisis.

Foreign investors were by no means the only ones who benefited from the stock market. To make a detailed assessment of the distributional consequences of these changes, would be useful to have statistics on the distribution of stock ownership in the country. Unfortunately, such data is hard to come by in a reasonable time series. Sudjana and Mishra, 2004 argue that the stock market remains an asset of the elite in Indonesia, with fewer than one percent of the population participating in it, and the vast majority of them being from upper income groups.

Stock market ownership is not well distributed even among the relatively wealthy. Evidence from Claessens et al, 2000 based on worldscope data suggest very high degrees of concentration in ownership. From the complex cross

holdings and pyramid structure of stock ownership in Indonesia, the authors disentangle the final owners/controllers of corporate stock in 1996. Table (4.20) below lists the percent of listed corporate assets that was controlled by the top family (the Suhartos), and the top 5, 10 and 15 families in 1996. The level of concentration of stock market control is the highest among all the East Asian countries studied by them.

It is inevitable then, that the run up of stock prices and the increase in capitalization led to a skewing of the wealth distribution towards the (very) rich and politically powerful. While there was a substantial increase in inequality seen in this period the official measure of inequality relies is consumption based rather than income based,(although information on the latter is available in the SUSENAS), and as such, probably underestimates the true level of inequality in the country. Sudjana and Mishra , 2004 also point to some compelling evidence in favor of this thesis. Noting that in the face of rising unemployment and underemployment, the post crisis years saw a consumption boom which would not have been possible without a substantial previous rise in income inequality.

To summarize, the capital market was moved from its moribund state by the financial system reforms of the late 1980s. In the 15 year period since then, it has developed rapidly and is now a central source of funding for firms in Indonesia. The strong growth of an alternative to a banking system that was and continues to be in serious difficulty is something that should be commended. At the same time, it is important to realize that the stock market remains an asset vehicle for the elite and that its benefits for the vast majority of Indonesia's populace as an instrument of savings are negligible. The wealthy, by contrast, have certainly gained from their ownership of rapidly appreciating assets. The movement in share prices is very strongly tied to global investors willingness and desire to invest in Indonesian stock, as evidenced by the run up and down turn in the

market in the mid 1990s. Given the narrow holdings of stock by the domestic populace, capital market development has bound the fortunes of Indonesia's wealthiest to the interests of global capital market investors.

4.5 Conclusion

If there is a guiding thread that can be discerned this chapter, it is that financial liberalization has been at the centre of profound changes in the political economy of Indonesia. To borrow from Polanyi, the financial system was once embedded within the developmental regime of the state and subordinated to the perceived requirements of the real sector. Once deregulated, however, the financial system generated imperatives of its own.

For the first twenty five years of the New Order government, the banking sector was used to allocate resources to sectors that were considered as having priority in the quest for egalitarian development. This was despite (or perhaps because of) the fact that in other important policy arenas, the government had already adopted laissez faire strategies. In particular, agricultural and rural growth was supported directly by subsidized credit. The effect of this was to trigger and bolster broad based egalitarian growth, and to engender a sharp reduction in urban and rural poverty.

Beginning in the mid 1980s, and more seriously from the late 1980s, programs of financial deregulation led to both a deepening of the financial system and to a greater involvement from the private sector. Credit growth was rapid and skewed towards urban areas. More substantively, with relatively poor oversight, the credit expansion occurred with massive asset debt mismatches in the banking sector. The result was seven years of rapid growth which increased inequality, but reduced poverty, followed by a devastating financial crisis which increased both: in short a pattern which followed closely Diaz-Alejandro, 1985 predictions.

The fallout of the crisis has been substantial. Politically, it overturned the Suharto regime after three decades in power, and replaced it with a democratic state. This is perhaps the single biggest 'benefit' of the crisis. While political plurality and the diffusion of political power was increasing through the 1980s, the notion of a democratic and viable state in the face of the pre eminence of the armed forces in everyday life appeared impossible even in the early 1990s (Macintyre, 1991). There is substantially greater political participation now than a decade ago.

This said, perhaps more consequentially for the lives of many ordinary Indonesians, liberalization and the crisis have also led to major changes in the priorities of the state. Where previously the state actively conceived of ways in which to transfer resources to various other sectors in line with a development plan, in the post crisis period, it has been preoccupied with the revitalization of the banking sector and with maintaining the confidence of the investing class. This has not been a costless reassessment of concerns. The state has taken on the burden of paying off the private debt incurred by imprudent firms and banks, a step that has come at the cost of vital development expenditure. Nor is this a problem that is likely to go away. Indonesia is perilously close to, if not already in, a debt trap. For the foreseeable future the state will continue to act as a guarantor of the financial sector. This is likely to lead to greater inequality.

Perhaps most distressing in this story is the lack of avenues to attempt a return to a broad based growth strategy. The green revolution is over as is the oil boom, concentration of corporate wealth and assets is very high and redistribution of these assets is unlikely to occur. Low tax revenues and the imperatives of bailing out the banking system prevent pro poor public expenditures.

Certainly financial liberalization alone cannot be held to be the sole cause for these changes. This said, it is a central element in the story, and one which has

not been adequately addressed. The lesson from the case of Indonesia is perhaps ultimately this: for policy makers interested in broad based egalitarian growth, finance can be a remarkable servant, but a ferocious and capricious master.

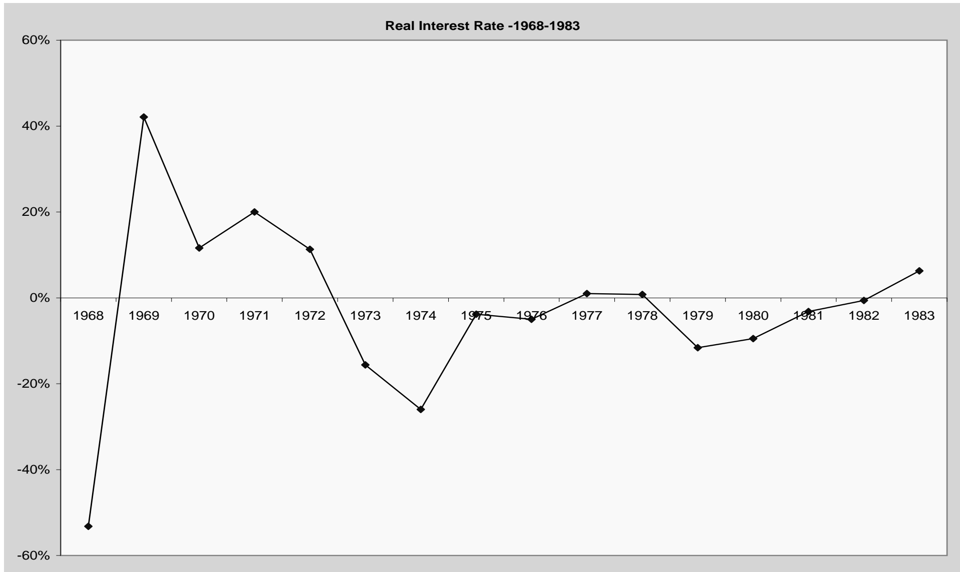

Figure 4.1. Real Interest Rates-1968-1983

Real Interest Rate is defined as the average of the state banks deposit rates minus the CPI rate of inflation.

Source: Indonesian Financial Statistics, Bank of Indonesia, various years.

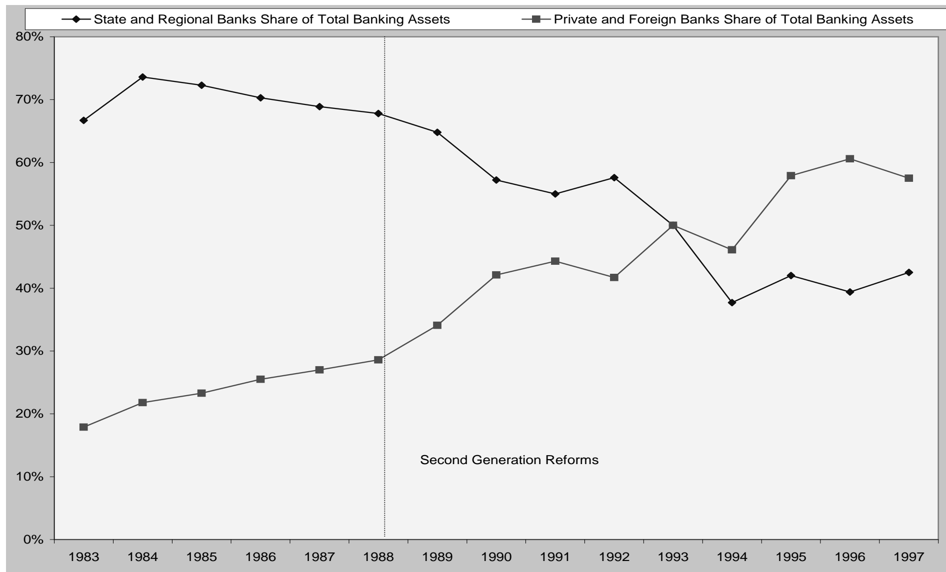

Figure 4.2. Changing Importance of State Versus Private Banks Following Reforms

Source: Hamada, 2003

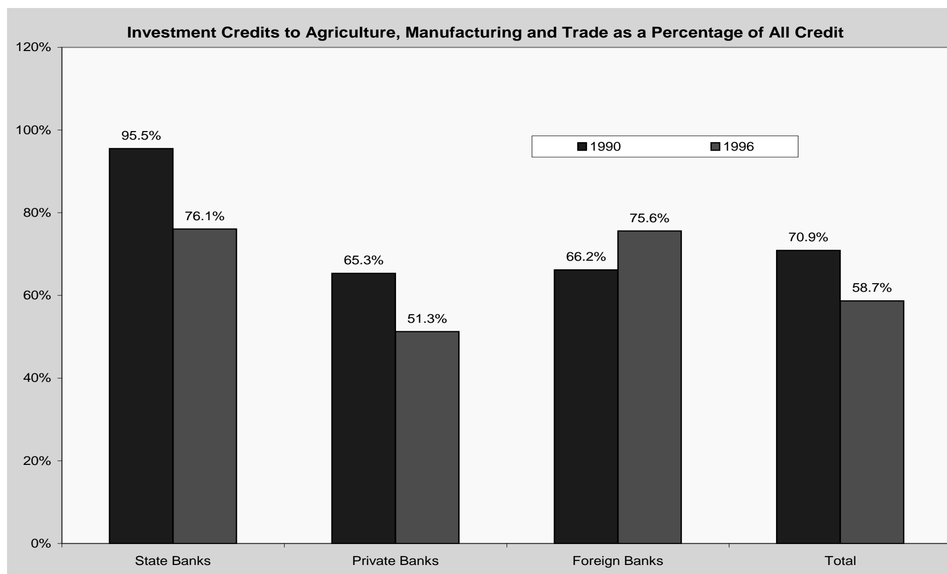

Figure 4.3. Declining Credit to Agriculture, Manufacturing and Trade

Source: Authors Calculation based on Bank of Indonesia,Indonesian Financial Statistics

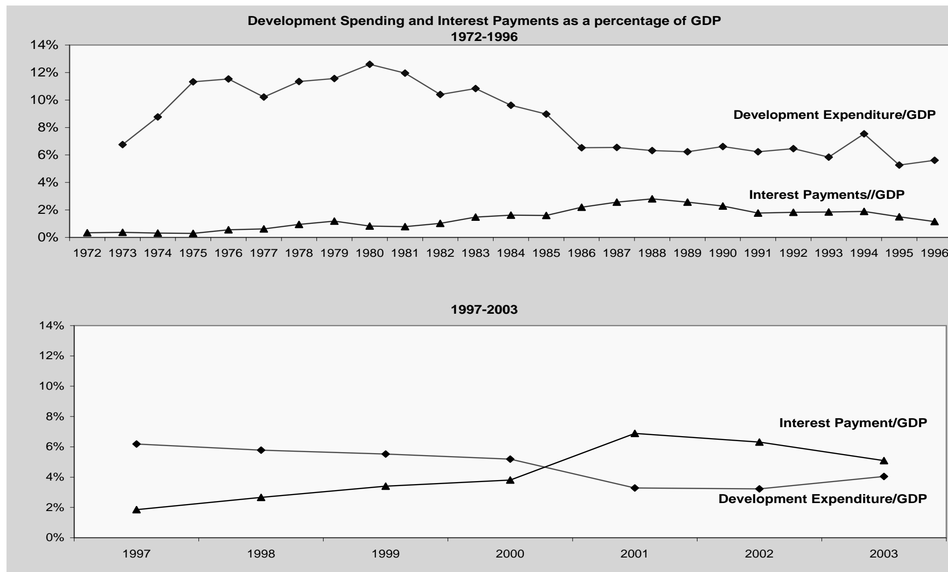

Figure 4.4. Development Spending and Interest Payments

Source: IMF Government Financial Statistics and World Bank Website on Indonesian Data and Statistics.

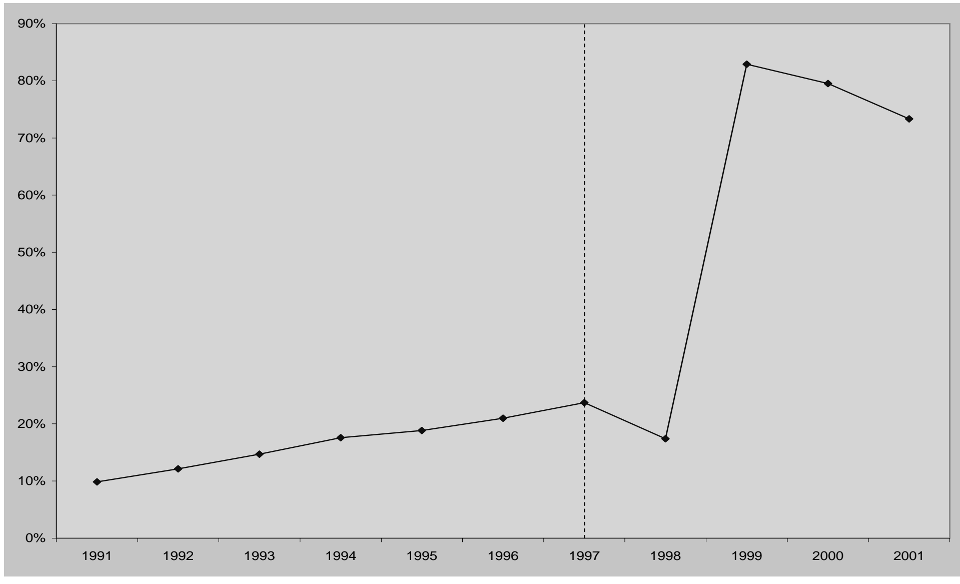

Figure 4.5. Ratio of Bond and Share Issues to Bank Loans

Source: Indonesia Capital Market Supervisory Agency, Bank of Indonesia, Financial Statistics

Table 4.1. Share in Total Bank Credit

Year	State and Regional Government Banks	Private and Foreign Banks
1967	45.8%	15.4%
1968	56.2%	8.0%
1969	56.2%	8.0%
1970	64.3%	9.1%
1971	69.3%	9.8%
1972	70.0%	10.6%
1973	72.8%	11.8%
1974	72.2%	13.1%
1975	58.2%	9.2%
1976	56.3%	9.7%
1977	58.1%	11.0%
1978	53.7%	10.4%
1979	53.6%	12.0%
1980	56.4%	12.5%
1981	60.3%	13.6%
1982	64.4%	14.3%
1983	66.7%	17.9%

source: Hamada, 2003

Table 4.2. Expenditure on Agriculture, Forestries and Fishing as % GDP

Year	Percentage of GDP
1973	1.3%
1974	2.5%
1975	2.0%
1976	2.2%
1977	2.0%
1978	1.8%
1979	1.8%
1980	2.2%
1981	1.9%
1982	1.7%
1983	1.4%

Source IMF Government Financial Statistics.

Table 4.3. Subsidized Credit to Agriculture

Year	Bulog	Farmers Credit	Total as % of all bank credit	Total as % of GDP
1968	29%	13%	42%	4.9%
1969	30%	11%	41%	3.7%
1970	17%	12%	29%	3.1%
1971	12%	10%	22%	3.0%
1972	14%	7%	21%	3.0%
1973	12%	7%	19%	2.8%
1974	13%	8%	21%	3.1%
1975	5%	8%	13%	2.8%
1976	5%	7%	12%	2.8%
1978	4%	5%	9%	1.9%
1979	4%	4%	8%	1.9%
1980	6%	3%	9%	1.8%
1981	8%	3%	11%	1.9%
1982	8%	4%	12%	2.1%
1983	7%	3%	10%	2.1%

Source: Macintyre, 1993 and Authors Calculation from Bank Indonesia, Indonesian Financial Statistics

Table 4.4. M2 to GDP 1967-1983

Year	M2 To GDP
1967	4.3%
1968	4.1%
1969	6.2%
1970	7.8%
1971	10.1%
1972	11.6%
1973	11.6%
1974	10.8%
1975	12.9%
1976	14.1%
1977	14.3%
1978	14.5%
1979	13.1%
1980	13.2%
1981	14.9%
1982	16.6%
1983	16.6%

Source: Global Development Finance, World Development Indicators

Table 4.5. Total subsidized credit to SME's as percent of all bank credit

Year	Percentage
1975	4%
1976	3%
1978	3%
1979	4%
1980	6%
1981	6%
1982	6%
1983	5%

Table 4.6. Poverty Incidence in Indonesia-1976-2000

Year	Urban	Rural	Total
1976	38.8	40.4	40.1
1980	29.0	28.4	28.6
1984	21.2	23.1	21.6
1987	20.1	16.4	17.4
1990	16.8	14.3	15.1
1993*	13.4	13.8	13.7
1996*	9.7	12.3	11.3
1996**	13.6	19.9	17.7
1998**	21.9	25.7	24.2
1999**	19.5	26.1	23.5
2000**	14.6	22.1	19.0

* based on new methodology of Indonesian Central Bureau of Statistics

* based on higher poverty line from expanded basket of goods

Source, Timmer 2004

Table 4.7. Trends in Gini Coefficient

Year	Urban	Rural	Total	Ratio of Expenditures of Top 20% to Bottom 20%
1969/70	0.33	0.34	0.35	5.7
1976	0.35	0.31	0.34	5.3
1978	0.39	0.34	0.38	6.2
1980	0.36	0.31	0.34	5.5
1981	0.33	0.29	0.33	5.1
1984	0.32	0.28	0.33	5.3

Source: Papanek,, 2004 and Hill (1996, p 193)

Table 4.8. Major Elements in Banking Sector Deregulation-1983-1987

Credit Ceilings	All credit ceilings established in the 1974 act abolished
Interest Rate Controls	All credit and deposit rate controls over state banks abolished
Foreign Currency Deposits	Taxation on interest earned in forex deposits abolished
Directed Credit	Reduction in priority programs from 32 areas to 20
Inter Bank Borrowing	Inter bank transfer ceilings reduced
Banking Restrictions	Fewer restrictions to new private banks and bank offices and non-bank financial institutions
Required Reserve Ratio	Significant reductions in reserve ratios from multiple rates averaging 11 percent to a uniform level of 2 percent of liabilities
Offshore Borrowing	Removal of limits to offshore borrowing
Regulations	Relaxation of regulations and capital adequacy ratios

Table 4.9. Growth Rates of Various Elements of Financial Market

Year	M1	State Forex Banks Credit	Private National Banks Credit	Foreign and Joint Venture Bank Credit
1990	22.1%	35.2%	88.1%	98.3%
1991	14.0%	11.8%	19.6%	37.8%
1992	9.6%	14.0%	1.2%	9.6%
1993	29.3%	4.8%	42.8%	57.9%
1994	19.9%	11.8%	42.8%	24.7%
1995	17.0%	16.8%	29.4%	32.0%
1996	26.2%	16.5%	34.3%	13.8%

Source: Bank Indonesia Financial Statistics

Table 4.10. Trends in Gini Coefficient 1990-2000

Year	Urban	Rural	Total
1987	0.32	0.26	0.32
1990	0.34	0.25	0.32
1993	0.33	0.26	0.34
1996	0.36	0.27	0.36
2000	0.32	0.24	0.31
2002	0.33	0.25	0.33

Source: Papanek, 2004

Table 4.11. Macroeconomic Effects of Crisis

	1994	1995	1996	1997	1998	1999	2000
GDP per capita ($)	3355	3489	3891	4136	3910	3831	4035
Capital Flows (billion$)	4008	10589	10989	2542	-3875	-4569	-6773
Private Capital Balance (billion$)	3701	10253	11511	-338	-13846	-9922	-9990
Exchange Rate (Rs/Dollar)	2160.7	2248.6	2342.2	2909.3	10013.6	7855.1	8421.7
Investment GDP Ratio (billion$)	0.198	0.243	0.211	0.209	0.132	0.101	0.106
Loans to GDP ratio (billion$)	0.593	0.516	0.55	0.602	0.389	0.203	0.208
Non Performing Assets/Loans (percentage)			10.60%	9.30%	19.80%	58.7%*	
Interest Rate on 1 month government bond(% per annum)			13.75%a	11.25%a	27.01%b	23.45%b	

a. December value b. Average of year * Accounting methods changed after December 1999 Sources; Penn World Tables and Hamada, 2003

Table 4.12. Changes in Employment and Wages between 1997 and 1998

MALES	Any work	Wage Earner	Self Employed	Family Worker	Real Wages*
Urban					
1997	71.90%	42.60%	27.20%	2.10%	1578
1998	69.70%	38.80%	28.30%	2.50%	1104
Rural					
1997	85.00%	27.90%	49.80%	7.30%	1048
1998	84.00%	24.40%	51.50%	8.10%	745
FEMALES					
Urban					
1997	37.00%	19.80%	12.50%	5.40%	1120
1998	37.00%	18.80%	12.20%	5.90%	835
Rural					
1997	51.70%	11.10%	18.60%	21.90%	772
1998	54.60%	11.20%	19.90%	23.40%	552

*=per hour

Table 4.13. Change in Real Wages Between:

	86-97	97-98	86-97	97-98
Wage Percentile	Males		Females	
10	47.8%	-35.9%	50.9%	-36.0%
30	49.0%	-35.9%	69.3%	-40.6%
50	43.6%	-36.8%	81.0%	-46.5%
70	36.9%	-36.7%	77.0%	-42.2%
90	33.5%	-36.4%	61.6%	-38.3%
95	37.7%	-37.4%	53.6%	-38.2%

Source: Smith et al, 2000

Table 4.14. Consolidation of Banking Sector

	Number of Banks		Share of Deposits (%)	
	June 1997	June 2000	June 1997	June 2000
State Owned *	34	44	37%	70%
Private	160	78	57%	18%
Foreign and Joint Venture	43	39	6%	12%

Source: Bank Indonesia Financial Statistics

Table 4.15. Central Government Debt as a Percentage of GDP

1972	41.5%	1985	31.7%
1973	32.1%	1986	49.9%
1974	21.9%	1987	50.3%
1975	21.1%	1988	53.6%
1976	21.0%	1989	43.7%
1977	19.9%	1990	42.4%
1978	30.6%	1991	36.6%
1979	22.3%	1992	39.3%
1980	17.3%	1993	37.5%
1981	16.8%	1994	36.6%
1982	27.9%	1995	30.8%
1983	28.60%	1996	23.90%
1984	25.40%	1997	72.50%

Source: Global Development Finance and World Development Indicators

Table 4.16. Dependent Variable: Development Expenditure/GDP

Period	1972-1998	1997-2003
Tax Revenue/GDP	.73* (8.3)	-0.103 (-.89)
Govt. Interest Payments /GDP	-0.11 (-.38)	-0.56* (-7.1)
Trend	-0.001* (-6.0)	-0.0003 (-0.28)
No of observations	26	6
R squared	0.90	0.98

*= significant at the 1 % level, t statistics in parentheses
sources: IMF government financial statistics and World Bank Country Data

Table 4.17. Debt and Interest Payments as a Percentage of GDP

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Dom. Debt	0.3%	0.7%	0%	0.7%	1.5%	37.9%	45.1%	46.8%	36.7%
Dom. Int. Payments	0%	0%	0%	0%	0.9%	2.2%	2.7%	4.2%	4.2%
For. Debt	34%	30.4%	25.0%	25.7%	74.7%	58.7%	53.8%	52.6%	45.4%
For. Int. Payments	1.7%	1.5%	1.9%	2.8%	2.7%	2.0%	1.6%	2.1%	1.7%

Source: Lim et al, 2004

Table 4.18. Major Elements in Capital Market Deregulation

Licensing	Fewer requirements for OTC shares and bonds (1987).
Price controls	Elimination of limitations on daily price movements(1987).
Stock Exchanges	Establishment of private securities exchanges with cross listings (1988).
Privatization	JSE privatized. Foreign ownership of stock permitted (1989).
Foreign Capital	Major deregulation: 100% foreign capital ownership allowed, minimum investment limits abolished(1994).

Source: Cole and Slade, 1996, Indonesia Capital Market Supervisory Agency

Table 4.19. Stock Market (Jakarta Stock Exchange) Development in Indonesia

Year	Shares Traded (Millions)	Value of Shares (Rp. Billions)	Number of Listed Companies	Composite Share Price Index
1977	0	0.2	1	
1978	0	0.2	1	
1979	0.1	1.3	4	
1980	1.7	5.7	6	
1981	2.9	7.7	9	
1982	5	12.6	14	
1983	3.5	10.1	23	
1984	1.2	2.1	24	
1985	1.9	3.0	24	
1986	1.4	1.8	24	
1987	2.5	5.2	24	
1988	6.9	30.6	24	
1989	95.8	964.3	56	
1990	702.6	7311.3	122	
1991	1007.9	5778.0	141	247.4
1992	1706.3	7953.9	153	274.3
1993	2844	19086.2	172	588.8
1994	5384	25482.8	218	469.6
1995	10646.4	32357.5	248	513.8
1996	29527.9	75729.2	267	637.4
1997	76599.1	120385.2	306	401.7
1998	90620.1	99684.7	309	398.1
1999	178486.5	147880	321	676.9
2000	134531.3	122774.8	347	416.3
2001	148381.4	97522.5	379	392.0

Table 4.20. Concentration of Stock Market Asset Ownership in Indonesia

Percent of listed corporate assets controlled by top:			
1 family	5 families	10 families	15 families
16.6%	40.7%	57.7%	61.7%

CHAPTER 5

CONCLUSIONS

> What is clear is that a simple ideological commitment to liberalization of financial markets cannot be derived either from economic theory or from an examination of a broad base of experience, and cannot provide the basis for an intelligent discussion of an absolutely central set of policy issues that face developing countries today.
> Joseph Stiglitz, 1993 (p.51)

Stiglitz's relatively early challenge to the orthodoxy of financial liberalization was prescient. The debate between the defenders of liberalization (Fisher,1930, McKinnon,1973, Shaw,1973) and those who have challenged their conclusions (Stiglitz 1993, Taylor,1983)has had its testing ground in the last decade in several developing economies. As increasing evidence has been brought to the matter, it appears that the orthodox predictions have not always been seen, and that the efficacy of liberalization depends on the existing financial environment and the speed of deregulation. As a result, the debate has swung back towards a less sanguine view of unfettered financial markets and more sympathy for the uses of intervention than before (Hellmann and Stiglitz, 1997).

This dissertation has further questioned the 'simple ideological commitment to liberalization of financial markets' by noting the consequences of the policy on another 'absolutely central issue': the question of distribution.In doing so it further substantiates a few early findings (Diwan, 1999, Harrison, 2002, Das and Mohapatra, 2002,Calderon and Chang, 2001) which found a correlation between financial openness and different measures of inequality.

This final chapter seeks to summarize the findings of the analysis undertaken in the first three chapters. A second task is to consider the policy implications directly resulting from the findings.

5.1 Summary of Findings

5.1.1 Cross Country Study

The central findings from chapter two that merit attention are as follows:

(a) Capital account openness, when measured by a sophisticated measure of openness has a strong, persistent negative impact on the labor share of income.

(b) The negative effects of openness on the labor share of income rise with income and the level of unionization.

(c) These findings are consistent with the notion of the race-to-the-bottom, and provides evidence for the contention that the bargaining power of labor is reduced vis a vis that of capital with increasing capital mobility.

(d) These effects are felt most strongly in high and middle income countries, while in low income countries, there is no significant relationship.

(e) Negative impacts on the labor share of income persist through time and remain in the presence of a series of plausible controls.

5.1.2 India Country Study

In chapter three-the India case study-the following points bear highlighting:

(a) Indian financial liberalization has been fairly extensive domestically and less extensive externally. The active management of liberalization has prevented crises and maintained healthy external balances.

(b) Banking sector reforms have improved the balance sheets of banks since the early 1990s.

(c) The role of banks as agents of development has been abandoned. This has led in turn to widespread financial disintermediation for a large number of vulnerable borrowers, particularly for rural credit but not limited to the sector. This may partly explain increasing rural deprivation.

(d) The sharp increase in interest rates through the mid 1990s following liberalization has increased the interest and debt burden for the exchequer. This has had statistically significant negative impacts upon the development expenditures of the state.

(e) The capital market has seen a surge in the last decade, with a capitalization that now competes with the asset base of the banking sector. Yet, the market is the province of a very small proportion of Indians. As a result, one can expect that wealth inequality, though unmeasured, may have risen.

(f) There is evidence of increasing wage inequality due to foreign direct investment. There were also increases in the value of land the metropolitan areas, which may have contributed to increased wealth inequality.

5.1.3 Indonesia Country Study

Finally, chapter four-the Indonesian study- makes the following central points:

(a) Indonesia, like India, used its financial sector for two decades as an agent of development, despite a relatively less regulated real sector and an open capital account.

(b) Rapid decreases in poverty, and improvements in agricultural growth and the welfare of the poor were in part due to the extensive system of credit allocations and directed credit.

(c) The transition to a more liberalized internal financial regime was done slowly and with a great deal of intervention between 1983 and 1988, followed by a period of more far reaching reforms from 1988 to 1992.

(d) A direct consequence of reforms was an explosion in private sector financial intermediation, without prudential regulations.

(e) The run up in the stock market has resulted in gains for a very small proportion of Indonesians.

(f) A classic Diaz-Alejandro type boom and bust cycle followed financial liberalization with massive capital inflows followed by equally severe reversals. The crisis had huge ramifications for poverty and inequality, the latter being underestimated because of the large capital flight during the time.

(g) Following the crisis, the government has absorbed the cost of the bailout and as a result, has seen a serious fiscal squeeze. There is a grave danger for Indonesia that it will fall into a debt trap which will further impoverish it.

5.2 Further Work and Policy Implications

At the time of writing, work on the effects of financial liberalization and its social impacts remains in its infancy. Yet the area of research possesses theoretical and empirical interest, and also speaks to crucial current debates about the global macroeconomic framework. I conclude by providing a list, by no means exhaustive, of some of the main implications of the findings in this dissertation.

First,capital account liberalization as a policy needs to be rethought. While liberalization may allow for static gains to be made in theory, there are several caveats to this in practice. Liberalization has not had tangible growth benefits. However, there is significant evidence that it increases macroeconomic instability, and from the results of this dissertation, to undesirable distributional outcomes. Policy makers must be allowed leeway to use controls in a manner to promote a better transition into the world economy. Case studies such as those by Epstein

et al, 2005) can help clarify the ways in which capital account regulations can help in this process.

Second, despite the undeniable inefficiencies of a state directed financial apparatus such as that in India in the 1980s and in Indonesia in the 1970s, such a system does what no other system can: channel resources to the urban and rural poor. The impact in India of liberalization has certainly been to create massive disintermediation. The 'third way'- civil society based credit mechanisms of microcredit- cannot adequately handle the requirements of large populations who find themselves rationed out of the formal credit system. In the financial sector, there is much to commend in the idea of bringing the state back in.

Finally, more attention needs to be paid to the effect of financial liberalization on the exchequer. Both in Indonesia and in India financial liberalization has led to increasing fiscal pressures and a slowdown in development spending.As such, internal constraints to achieving growth and development are exacerbated by a rapid move toward global integration. In the case of Indonesia, the pressure is now acute since the crisis has necessitated a massive public bailout. The losers in this case are those who are most dependent on public and social spending. The case of India is interesting because despite increasing pressures, the country has so far been spared the worst effects of rising interest spending, at least partly because of its judiciousness in absorbing primarily long term rather than short term debt. On the other hand, financial deepening may also present opportunities. One policy measure to augment the resource base for both countries is to impose a securities tax. Financial liberalization in both countries has resulted in the creation of and a rapid growth in the stock market. Given that shares are an asset vehicle of the elite, this is a simple and progressive tax that may become more popular over the years.

This work is a beginning in the sense that it has simply accounted for and traced the distributional consequences of a liberal financial regime. Further work on capital account liberalization and distribution would seek to build on the second chapter and analyze the conditions and countries in which capital mobility has the most profound negative and positive effects on factor shares. Chapters 3 and 4 provide equally compelling questions which have been left unanswered. How may second generation banking reforms in both Indonesia and India provide financial intermediation to those who have been forced out, while at the same time managing efficiency and profitability in a more competitive environment? How can the countries raise the resource base of the state in a way to promote desperately needed public expenditure? In what ways does the explosion of credit availability at the upper ends of the income distribution impact social outcomes? These and many more questions, it is hoped will be asked by researchers in the coming period. Both theoretically and empirically, these linkages need to be understood in greater detail. As such, it is hoped that this study may constitute a beginning in constructing an alternative paradigm through which developing countries can undertake to integrate with the global economy, but under the terms and conditions that may promote egalitarian growth.

APPENDIX A

AN INDEX OF CAPITAL ACCOUNT OPENNESS

Researchers have long been aware of the problem of using simplistic dummies such as the binary variable from the International Monetary Fund annual report on exchange restrictions.As a result,some have made efforts to construct continuous measures for the intensity of capital account controls. Among these, the index created by Quinn (1997) remains the first, and most popular. Quinn's index makes careful use of the text of the IMF report to code an index with a value from 0 to 4 with a scale of 0.5[1]. His coding rules for capital receipts and payments is as follows.

If approval is rare and surrender of receipts is required,then X=0.

If approval is required and sometimes granted, then X=.5.

If approval is required and frequently granted, then X=1.

If approval is not required and receipts are heavily taxed, then X=1.5.

[1]Quinn also constructs the index for current account restrictions, exchange rate restrictions,acceptance of IMF article VIII and multilateral agreements to get a composite measure of openness.

If approval is not required and receipts are not taxed, then X=2 (Quinn, 1997, p. 544.).

Based on this rule, he presents the following examples of coding in his paper (Quinn, 1997). According to his rules, the capital account openness index has a value of 1 for India in 1979 for example, while the US has a value of 4 and Sweden has 3.

India

Capital: Payment
Residents are prohibited, except with Reserve Bank permission, from engaging in any transaction which increases beyond 49 percent the nonresident share of business outside India and they are also prohibited, except with Reserve Bank permission, from holding, acquiring, transferring, or disposing of immovable property outside India. Furthermore, Reserve Bank approval is required for residents exporting Indian securities to any place outside India and transferring Indian securities to nonresidents (IMF 1980 report, p. 196) Indian nationals are not normally granted any exchange facilities for emigration purposes (p. 197)
.
Comments: Approval required, rarely granted.
Score: 0.5

Capital: Receipts
All proposals for direct investment in India, with or without equity participation, are reviewed by the Foreign Investment Board. The General or specific approval of the Reserve Bank is necessary for the continuance of commercial, industrial, or trading activities in India or companies incorporated abroad, or with more than 40 percent nonresidents interest (p. 191). [Details of conditions for continuation of business in India provided, including equity dilution formulas. pp. 195-61.] In exceptional cases, companies that do not meet these criteria but have developed skills , or use technologies not indigenously available, may be permitted a more than a 40 percent foreign participation. Branches of foreign companies other than airlines, shipping companies, and liaison offices must in all cases become Indian companies (p. 196).

Comments: Approval required for all direct investments. Extensive and pervasive indigenous equity requirements. Some “national interest” investments permitted outside guidelines.
Score: 0.5

United States

Capital: Payment Incoming or outgoing capital payments by residents or nonresidents are not subject to exchange controls. In addition inward and outward direct or portfolio investment is generally free of any other form of approval (IMF 1980 report. p.424).

Comments: Essentially free.
Score: 2.0

Capital: Receipts Incoming or outgoing capital payments by residents or non-residents are not subject to exchange controls. In addition inward and outward direct or portfolio investment is generally free of any other form of approval (p.424).

Comments:Free.

Score: 2.0

Sweden

Capital: Payment Direct investment abroad by Swedish residents requires individual authorization, which normally is granted only if the investment is considered likely to promote exports or otherwise to benefit the balance on the current account, regardless of the return on the investment. Residents do not need authorization to sell portfolio holdings of foreign securities to nonresidents. The purchase of both listed and unlisted securities by residents from nonresidents requires authorization. As a rule, such authorization is not granted (p. 385).

Comments: Approval required for direct investments; some capital payments and capital sales permitted. Score: 1.0

Capital: Receipts Foreign direct investments in Sweden require authorization, which normally is given, provided that not more than 50 percent of each individual investment (investments below SKr 5 million excepted) is financed with domestic credit. Residents are permitted to receive capital receipts from abroad only upon approval of the Rijksbank (p. 384). Permission is needed for the issuance of bonds and shares in Sweden by nonresidents; bond issues in favor of other Scandinavian countries and [the World Bank] have been admitted (p. 385).

Comments: Approval required for all large and many small nonresidents financial activities. Some approvals denied.
Score-1.0 (Quinn, 1997, pp. 541-544).

Although this index is limited in not disaggregated adequately between various types of flows and various taxes on these flows (a practice that the IMF has begun to take in reports subsequent to 1996), it remains the most reliable. Many recent studies use this index and in doing so suggest that the measure picks up more variation and is more accurate than a simple dummy (Edwards 2001). Unfortunately, this index is made public only for a select number of years. For OECD countries, the data are available for all years from 1958 to 1997, while data is available for the rest of the sample only for 1958, 1972, 1982 and 1988. Moreover, the coverage of countries is only 70 countries in total.

In Lee and Jayadev, 2003, we reconstruct a Quinn-like index, reviewing the IMF report following the same methodology for a large sample of countries. We use the following coding rule, which is slightly more developed (using more information from the IMF)but very similar to Quinn's original index.

If approval is rare and surrender of receipts is required, then X=0.

If approval is required in most parts and sometimes granted, then X=.5

If approval is required in some parts and frequently granted, then X=1

If license or any regulation exist in most parts, then X=1

If approval is not required and receipts are not heavily taxed, then X=1.5.

If approval is required in only few parts and usually granted,then X=1.5

If license or any regulation exist only in a few parts, then X=1.5

If approval is not required and receipts are not taxed, then X=2

If regulation doesn't exist in almost all parts, then X=2.

This methodology was used to code data from 1972 to 1996 for more than 130 countries in the IMF report. Given that the IMF data is qualitative, we added certain criteria which are available in the report. Since the index involves certain judgment calls, we used 3 separate coders to check for consistency.

The table below represents the correlation matrix between our measure, that of Quinn and that of the International Monetary Fund. The last of these is a binary measure of openness available from the IMF annual reports(see for example, Murshid and Mody, 2002) As can be noted, we have a very high correlation between our index and that of Quinn's for the OECD countries (.97) and a lower but large correlation between our index and that of Quinn for the non OECD countries. For the overall sample, the correlation coefficient between Quinn's index and ours is .91. Much of the variation derives from our added criteria.

Table A.1. Correlation Matrix Between Quinn, IMF and Lee-Jayadev index for OECD countries

	Quinn	IMF	Lee-Jayadev
Quinn	1	0.67	0.97
IMF	0.67	1	0.71
Lee-Jayadev	0.97	0.71	1

APPENDIX B

COUNTRY CLASSIFICATION

The table overleaf lists the countries used in the panel data analysis of chapter 2 by the income groupings of the world bank.

High Income Countries			Middle Income			Low Income		
Australia	1973	1995	Algeria	1973	1994	Angola	1989	1990
Austria	1973	1995	Argentina	1993	1995	Benin	1975	1989
Bahamas	1989	1995	Bahrain	1975	1995	Burkina Fas	1982	1985
Belgium	1973	1995	Barbados	1974	1975	Cameroon	1975	1995
Canada	1975	1995	Bolivia	1973	1992	Chad	1975	1995
Denmark	1975	1995	Botswana	1978	1995	Congo, Rep.	1975	1989
Finland	1973	1995	Bulgaria	1990	1995	Cte d'Ivoire	1973	1995
France	1973	1995	Chile	1973	1995	Ghana	1977	1986
Germany	1980	1995	Colombia	1975	1995	Guinea-Bissau	1986	1987
Greece	1973	1995	Costa Rica	1980	1995	Haiti	1976	1976
Hong Kong	1980	1995	Dominican Rep.	1994	1995	Honduras	1975	1995
Iceland	1973	1995	Ecuador	1975	1993	Kenya	1973	1995
Ireland	1975	1995	Egypt	1975	1979	Malawi	1973	1986
Israel	1973	1995	El Salvador	1990	1993	Mali	1978	1982
Italy	1973	1995	Fiji	1977	1995	Myanmar	1973	1995
Japan	1973	1995	Gabon	1975	1989	Nepal	1975	1983
Kuwait	1976	1995	Guyana	1975	1975	Nicaragua	1973	1978
Malta	1973	1995	Hungary	1981	1995	Niger	1975	1983
Netherlands	1973	1995	Iraq	1973	1991	Nigeria	1973	1994
New Zealand	1973	1995	Jamaica	1973	1988	Rwanda	1975	1989
Norway	1973	1995	Jordan	1975	1995	Senegal	1974	1979
Portugal	1973	1995	Korea, Rep.	1973	1995	Sierra Leone	1973	1990
Qatar	1995	1995	Libya	1973	1985	Sudan	1973	1993
Singapore	1988	1995	Malaysia	1978	1983	Tanzania	1973	1994
Spain	1973	1995	Mauritius	1973	1995	Togo	1974	1981
Sweden	1973	1995	Mexico	1973	1995	Zambia	1973	1990
Switzerland	1975	1995	Morocco	1973	1980	Zimbabwe	1979	1989
United Arab Emirates	1973	1990	Oman	1976	1995			
United Kingdom	1975	1995	Panama	1973	1995			
United States	1973	1995	Papua New Guinea	1975	1991			
			Paraguay	1973	1995			
			Peru	1973	1995			
			Philippines	1973	1995			
			Poland	1991	1995			
			Romania	1980	1995			
			Saudi Arabia	1973	1995			
			South Africa	1973	1995			
			Sri Lanka	1973	1995			
			Suriname	1975	1994			
			Swaziland	1980	1987			
			Thailand	1975	1995			
			Trinidad an	1973	1995			
			Tunisia	1985	1995			
			Turkey	1973	1995			
			Uruguay	1975	1991			
			Venezuela	1973	1995			

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