# Chapter VI
# Economic liberalization and poverty reduction

Economic liberalization encompasses the processes, including government policies, that promote free trade, deregulation, elimination of subsidies, price controls and rationing systems, and, often, the downsizing or privatization of public services (Woodward, 1992). Economic liberalization has been central to adjustment policies introduced in developing countries since the late 1970s, mostly in the context of the conditions for lending set by international financial institutions. Thus, government policies were redirected to follow a non-interventionist, or laissez-faire, approach to economic activity, relying on market forces for the allocation of resources. It was argued that market-oriented policy reforms would spur growth and accelerate poverty reduction.

From this perspective, government intervention in markets is seen as both inefficient and distortionary. It is argued that even if an interventionist State acts with good intentions, it does not have the competence to manage the economy well. By moving scarce resources into less productive economic activities, the State is thought to reduce overall economic growth, with adverse consequences for poverty reduction.

Additionally, for public choice theory, rational, self-interested individuals maximize their economic benefits and overall economic welfare. In civic life, politicians, bureaucrats and citizens are all considered to act solely out of self-interest in the political arena. Politicians and State bureaucrats, acting from self-interest, use their power and the authority of the Government to engage in rent-seeking behaviour, which distorts the allocation of resources and results in disincentives for private investment and entrepreneurship (Buchanan, 1980). Therefore, the power of the State and political actors, including the ability to intervene in the economy, should be limited.

Within this framework, the State creates enabling conditions in the form of macroeconomic stability, guaranteeing property rights, and maintaining law and order for rapid economic growth driven by private sector (both domestic and foreign) investment. As economic growth rises, poverty will fall (Dollar and Kraay, 2002). Distribution and social justice benefit from the trickle-down principle, as economic growth will eventually benefit all members of society. The free market, based on comparative advantage, will thus bring about economic expansion through labour-intensive export activities, which will create employment and hence improve the general well-being of the entire society.

The present chapter critically evaluates the growth, employment and poverty impacts of three major elements of recent economic liberalization—trade liberalization, financial liberalization and privatization.

## Trade liberalization

### Trade and economic growth: the theory

Proponents of trade liberalization expect that removing trade barriers will lead to short-run or static welfare gains (or higher income levels) and in turn reduce poverty.[1] The gains from trade result from the fact that different countries are endowed with different resources (natural and acquired); hence, the opportunity cost of producing products varies from country to country. Opportunity cost is measured by the sacrifice (for example, in the production of one good) to produce *one extra unit* of another good, given that resources are scarce. Under trade protection, resources are concentrated in inefficient production in economic sectors that have high trade barriers. When barriers are removed, resources shift away from those inefficient sectors in which that country has no comparative advantage to the efficient sectors in which it does have a comparative advantage.

Gains from trade may not be distributed equitably and are determined by several factors, including the international rate of exchange between two goods, what happens to the terms of trade, and whether the full employment of resources is maintained as they are reallocated when countries specialize (see box VI.1). The closer the international rate of exchange is to a country's own internal rate of exchange, the less it will benefit from specialization and the more the other country will benefit. As Bhagwati (1958) has shown, in extreme circumstances, one country may become absolutely worse off if real resource gains from trade are offset by the decline in the terms of trade, a phenomenon that he called "immiserizing growth" (Bhagwati, 1958).

The problem for many developing countries is that the type of goods in which they will specialize under a free trade regime—namely, primary commodities—is likely to cause the terms of trade to deteriorate and may lead to an underutilization of their resources. First, primary commodities generally

1 Neoclassical economic theory has long contended that trade enhances welfare and growth. In his *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), Adam Smith stressed the importance of trade as a vent for surplus production and as a means of widening the market, thereby improving the division of labour and the level of productivity. Smith maintained the following:

> Between whatever places foreign trade is carried on, they all of them derive two distinct benefits from it. It carries the surplus part of the produce of their land and labour for which there is no demand among them, and brings back in return something else for which there is a demand. It gives value to their superfluities, by exchanging them for something else, which may satisfy part of their wants and increase their enjoyments. By means of it, the narrowness of the home market does not hinder the division of labour in any particular branch of art or manufacture from being carried to the highest perfection. By opening a more extensive market for whatever part of the produce of their labour may exceed the home consumption, it encourages them to improve its productive powers and to augment its annual produce to the utmost, and thereby to increase the real revenue of wealth and society.

Box VI.1

**Trade liberalization and exports in Africa**

According to proponents of trade liberalization, increased exports following trade liberalization will ensure higher rates of economic growth, beneficial for the poor. However, Africa's export performance following trade liberalization does not support such claims. While greater market access may well have led to the achievement of the expected results, trade liberalization resulted in the loss of tariff revenues, eroding fiscal space, and undermined existing productive capacities and capabilities.

Most African countries have liberalized their trade regimes. Trade liberalization occurred principally from the late 1980s and in the 1990s, and involved the "tariffication" of non-tariff barriers, cuts in the number and value of tariffs, exchange-rate liberalization and removal of export barriers. Overall, export performance in African countries following trade liberalization has been disappointing. Indeed, although trade liberalization has increased exports expressed as a percentage of GDP, this effect has been weak, and trade balances in African countries have deteriorated since liberalization with greatly increased imports.

Analysis of values and volumes of exports from Africa show that, following liberalization, African exports continued to grow at slower rates in volume terms than in other regions. Only the rising prices of fuels, minerals and other primary commodities since 2002 have maintained African export value growth at levels comparable with that in other developing regions.

Export diversification is very low in Africa, an outcome consistent with the theory of comparative advantage. African countries remain principally primary commodity exporters, as dictated by their resource endowments. Thus, the dependence of most African countries on a small number of export products has increased following liberalization. Many countries in the region are now less able than before liberalization to withstand price collapses for a few key commodities.

The main destinations for African exports do not appear to have been strongly affected by African countries' efforts to liberalize trade. Although there has been some diversification in the destinations of African exports, the declining importance of European countries as export markets seems to be part of longer-term trends in growth and demand, unrelated to trade liberalization. The greater importance of Asia as a market for African exports reflects strong growth in that region requiring African primary commodities, especially minerals. Recent changes in the share of African exports going to North America, meanwhile, have been driven mainly by determined United States efforts to diversify oil supplies and corporate investment in sub-Saharan Africa.

**Source:** United Nations Conference on Trade and Development (2008).

have low prices and the demand for them does not rise as fast as income (low income elasticity of demand). As a result, when their supply increases, prices can drop dramatically, since demand grows only slowly with income growth. Secondly, primary commodity production is land-based and subject to diminishing returns,[2] and there is a limit to employment in activities subject to diminishing returns at a reasonable living wage.

By contrast, in manufacturing, no fixed factors of production are involved, and production may be subject to increasing returns. Thus, what is often ob-

2 When all inputs are increased proportionately, output does not increase by the same proportion. This happens in land-based activities as the availability of better-quality land diminishes. On the other hand, when output increases more than proportionately with proportionate increases of all inputs, this is described as increasing returns to scale.

served is a secular deterioration of the terms of trade for countries producing primary commodities vis-à-vis countries specializing in manufacturing (Ocampo and Parra, 2003). Therefore, in practice, for countries specializing in activities subject to diminishing returns, the real resource gains from specialization may be offset by the real income losses from unemployment.

Empirical studies do not point to significant employment generation due to trade liberalization.[3] Furthermore, according to a World Bank study, more than 70 per cent of gains from complete trade liberalization will accrue to rich countries, and more than two thirds of static gains to developing countries from complying with the outcomes of the Doha Round will go to big countries such as Argentina, Brazil and India in the case of agriculture and to China and Viet Nam in the case of textiles and garments (Anderson and Martin, 2005).

According to proponents of trade liberalization, the major reason for the rapid growth arising from trade liberalization is the dynamic gains from trade. The dynamic gains accrue from augmenting the availability of resources for production by increasing the quantity and productivity of resources. One of the major dynamic benefits of trade is that it widens the market for a country's producers. If production is subject to increasing returns, export growth becomes a source of continued productivity growth since there is also a close connection between increasing returns and capital accumulation. For a small country with no trade, there is very little scope for large-scale investment in advanced capital equipment, and specialization is limited by the extent of the market. Other important sources of dynamic benefits from trade include: stimulus to competition, acquisition of new knowledge and ideas and dissemination of technical knowledge, more FDI, and changes in attitudes and institutions.

Trade can raise productivity, however, if increasing returns to scale are dominant in the export sectors. If, instead, scale economies are more widespread in import-competing sectors which contract after liberalization, productivity gains will be limited. Another possibility is that protection increases inefficiency by drawing too many firms into sectors shielded from foreign competition. Liberalization brings about rationalization and increased productivity. This will occur, however, only if there is ease of entry and exit into markets. In reality, firms may remain in an industry for a long while after protection is lifted, thus limiting increases in productivity. Finally, if competition for export markets is intense, uncertainty may make firms reluctant to undertake new productivity-enhancing investments.

## Empirical evidence

The high-performing Asian economies have provided the main reference point for the resurgence of claims about trade liberalization. The economies of Japan;

3 See chapters by G. Andrea Cornia, Eddy Lee, and Bernard Hoekman and L. Alan Winters in Ocampo, Jomo and Khan, eds. (2006).

the Republic of Korea; Taiwan Province of China; Singapore; Hong Kong Special Administrative Region, China; Malaysia; Indonesia; and Thailand have recorded some of the highest GDP growth rates in the world—averaging approximately 6 per cent per annum from 1965 until 1990—and also some of the highest rates of export growth, averaging more than 10 per cent per annum. Thus, quite often, their spectacular economic success has been linked to exports or outward orientation, notwithstanding the 1997-1998 economic crises in East Asia.[4] However, this success has hardly been based on free trade or laissez-faire (see box VI.2). For example, the Governments of Japan and the Republic of Korea have been highly interventionist, pursuing export promotion on the basis of import substitution (Amsden, 1989; Chang, 2006). The World Bank (1993) has acknowledged that what is important for growth is not whether the free market rules or the Government intervenes, but rather getting the fundamentals for growth right, including government control of financial markets in order to lower the cost of capital, and policies to promote exports and protect domestic industry.

Box VI.2

**Did trade liberalization reduce rural poverty in China?**

China's success in reducing poverty with the reforms of 1978 is undeniable. The 1980s and 1990s saw a significant fall in rural poverty. However, as Ravallion and Chen (2004) argue, this had very little to do with trade liberalization. Several other factors were at work.

The specifics of the situation in China at the outset of reform should not be forgotten. The Great Leap Forward and the Cultural Revolution had not helped reduce rural poverty in the period from the 1960s to the mid-1970s. Most of the rural population, forced into collective farming, had weak incentives to work and produce productively. Hence, there were some relatively easy gains from de-collectivizing agriculture and shifting the responsibility for farming to households. This brought a huge gain to the country's poorest, but a one-time gain.

In China, the Government operated an extensive food grain procurement system which effectively taxed farmers by setting quotas and fixing procurement prices below market levels. By raising the procurement prices, the Government of China brought both poverty and inequality down in the mid-1990s. When so many of a country's poor are to be found in its rural areas, it is not surprising that agricultural growth plays an important role in poverty reduction. China's experience is consistent with the view that agriculture and rural development are crucial to pro-poor growth in low-income developing countries.

Why did agricultural growth have strong poverty-reducing effects in China? Relatively equitable land allocation was achieved by breaking up collective farms. Most farmers, therefore, had efficiently sized plots. Farmers who owned small plots of land and lacked incentives to invest in new technology were not common, though they were common in many other developing countries.

**Source:** Ravallion and Chen (2004).

4 Brahmbhatt and Dadush (1996) found that, among 93 developing countries studied, the rapidly growing East Asian exporting countries were integrating fastest into the global economy, while low-income countries of sub-Saharan Africa and some middle-income countries in Latin America were integrating less or more slowly.

A later study by the World Bank (2002) of both economic growth and equality in developing countries from 1977 to 1997 found that the more globalized countries (as measured by trade relative to GDP) enjoyed faster economic growth, but did not experience significant changes in income inequality. However, as Rodrik (2001, p. 1) points out, "the countries that integrated into the world economy most rapidly were not necessarily those that adopted the most pro-trade policies". According to Rodrik, "the Bank is acknowledging that trade liberalization may not be an effective instrument, not just for stimulating growth, but even for integration in world markets". Rodrik concludes that "rapid integration into global markets is a consequence, not of trade liberalization or adherence to World Trade Organization strictures per se, but of successful growth strategies with often highly idiosyncratic characteristics".[5]

Thus, both the 1993 and 2002 studies of the World Bank recognize that high growth was not necessarily due to trade liberalization or export orientation. What matters most is the successful growth strategies based on countries' own historical and socio-economic circumstances. The empirical work claiming a positive causal relationship between trade liberalization and growth suffers from serious methodological flaws. After careful evaluation of the major cross-country empirical work, one study states that "[w]hen we ask whether the results are informative for the practice of trade policy, we conclude that the answer is 'no' " (Hallak and Levinsohn, 2004, p. 3).[6] A later study (Andersen and Babula, 2008) which addresses some flaws of earlier ones finds likely positive links between trade and economic growth, but doubts the ability of developing countries to achieve productivity growth through trade liberalization. To do so, it may well be necessary to invest enough in appropriate education and training facilities. However, by removing an important source of revenue through tariff reductions—which is not compensated for by other sources of revenue—trade liberalization further restricts Governments' fiscal space for such productivity-enhancing investment (see box VI.3).

Summarizing lessons from a decade of reforms in the 1990s, the World Bank (2005, p. 134) notes:

> The distributive effects of trade liberalization are diverse, and not always pro-poor. … evidence from the 1990s suggests that even in instances where trade policy has reduced poverty, there are still distributive issues … Global markets are the most hostile to the products produced by the world's poor—such as agricultural products and textiles and apparel.

5 The admission in question comes when the report describes its sample of "more globalized" countries: "We label the top third 'more globalized' without in any sense implying that they adopted pro-trade policies. The rise in trade may have been due to other policies or even to pure chance" (World Bank, 2002, p. 34).

6 For a similar conclusion, see Rodríguez (2007).

Box VI.3

**Fiscal impact of trade liberalization**

Although there are large differences among countries, income from trade taxes represents, on average, one third of total tax revenues in developing countries. In some very open and small least developed economies, import-related taxes constitute as much as 65 per cent of total revenue (see Gupta, 2007). Laird and de Córdoba (2006) show that developing countries obtain about $156 billion in tariff revenues annually, but this base would fall by 41 per cent under the ambitious "Swiss formula" proposal of tariff cuts for non-agricultural products. The study also shows tariff losses of at least $63 billion for developing countries due to non-agricultural market access (NAMA) alone, against projected welfare gains of less than $16 billion (0.2 per cent of developing-country national income) from the Doha Round.

With promises of $4 billion against such high fiscal losses due to trade liberalization, Aid for Trade may not be of much help for developing-country Governments. For some countries, the fiscal loss from trade liberalization could be as high as 10 per cent of GDP, which is more than their public expenditure on health, education and other social priorities combined.

Between 1970 and 1998, 84 low- and middle-income countries surveyed experienced lower fiscal revenue as a result of falling trade-related tariffs (see International Monetary Fund, 2002). IMF recommends replacing the trade-related revenues with value-added and sales taxes. However, the proposed substitution raises questions of feasibility and equity. In terms of feasibility, the capacity of low-income countries to recover income losses is limited. Implementing indirect taxes (value-added and sales taxes) demands increased administrative capacity which many countries do not have; and for every dollar lost in tariffs, poor and middle-income countries have been able to recover, at best, 30 cents from other sources (see Baunsgaard and Keen, 2005). Thus, while the consumption-based indirect taxes fail to compensate for the lost tariff revenues, they are also found to be regressive, and disproportionately affect low- and middle-income households.

The IMF Trade Integration Mechanism (TIM) did not contemplate the loss of fiscal revenues from the outset. This was only explicitly added in a recent reformulation of the mechanism in the context of the Aid for Trade discussion. As the Fund facilities are not concessional, this means that a rate similar, or very close, to the market interest rate must be paid on the borrowed funds. Hence, the Mechanism basically increases debt in order to compensate for an ostensibly temporary adjustment of the balance of payments.

## Financial liberalization

The arguments for financial liberalization also rest on the supposed link between financial development and economic growth, and hence poverty reduction. There are two dimensions of financial liberalization: (*a*) domestic financial sector deregulation and (*b*) opening of the capital account.

The rationale for financial deregulation, including international financial liberalization, was provided back in the early 1970s by McKinnon (1973) and Shaw (1973). They claimed that one of the reasons for the poor growth performance of many developing countries had been administratively determined very low (in some cases, negative) real interest rates which discouraged savings and encouraged inefficient use of capital. Thus, financial liberalization—primarily involving deregulation of interest rates—would lead to higher levels of savings. Liberalization would also channel funds to finance more productive projects. Therefore, an increase in real interest rates following liberalization should encourage saving and expand the supply of credit available to domestic investors, thereby enabling the economy to grow more quickly. This growth-promoting effect of domestic financial sector deregulation should be enhanced by opening the capital account of the balance of payments, which would allow more foreign capital to flow into the country, attracted by higher domestic real interest rates.

While increases in real interest rates have often been the outcome of liberalization episodes, their impact on domestic saving and investment has been mixed (Reinhart and Ioannis, 2008; Galbis, 1993). McKinnon himself has acknowledged that financial liberalization may lead to episodes of "over-borrowing". This over-borrowing syndrome may be magnified when domestic liberalization is coupled with capital account liberalization (McKinnon and Pill, 1999). Additionally, if the rising levels of debt are denominated in a foreign currency, this will increase a country's vulnerability to exchange-rate fluctuations. Banking crises are often preceded by financial liberalization; indeed, liberalization often leads to crisis (Kaminsky and Reinhart, 1999). A World Bank study of 53 countries for the period 1980-1995 found that banking crises were more likely to occur in liberalized financial systems (Demirgüç-Kunt and Detragiache, 1999; see also box VI.4). One reason why China, India and Viet Nam remained relatively unaffected by the contagion from the Asian financial crisis was their tight controls on short-term capital flows.

Box VI.4

**Financial crises and poverty**

Financial liberalization has increased the frequency and intensity of financial and banking crises, especially in emerging economies. Liberalization of the capital account increases the inflow of foreign capital but also threatens the stability of financial institutions by increasing exchange-rate and domestic lending risks.

A conspicuous feature of capital account liberalization in developing countries is so-called liability dollarization. This occurs when the private sector acquires liabilities in foreign currency, although assets are denominated in local currency. This makes the balance sheet of the private sector highly sensitive to shifts in the exchange rate. Significant exchange-rate depreciations can lead to large and negative wealth effects as liabilities increase in value relative to assets. Such wealth effects often cannot offset the positive impact on competitiveness engendered by exchange-rate depreciations.

Developing countries often experience sharp changes in capital flows. The most damaging in terms of impact on real output, employment and wages are so-called sudden stops, when there is an unanticipated cessation of capital flows that is not linked to any systematic policy errors committed by developing-country Governments. These sudden stops reflect failures and shortcomings in international capital markets. Under normal circumstances, Governments would seek to mitigate the impact of a capital account crisis on the real economy by engaging in counter-cyclical policies.

Unfortunately, the presence of liability dollarization—as well as the lack of preparedness—acts as a binding constraint on policy space. Monetary authorities develop a "fear of floating" and thus are reluctant to allow the depreciation of the exchange rate and engage in expansionary policies because of the rather large negative wealth effect stemming from liability dollarization.

Cline (2002) has tracked the path of per capita income growth before, during and after the year of a financial crisis triggered by sudden large outflows of foreign capital for each of eight major cases. In every case, there was a decline in per capita growth in the crisis year, most dramatically a decline by 15 per cent in the case of Indonesia. The financial crises between 1994 and 2002 impoverished at least 40 million–60 million people, and possibly almost as many as 100 million, out of a total of 800 million people in the economies concerned. By far the largest adverse impact occurred in Indonesia, owing to the country's large income decline and large share of population in poverty.

Thus, by the end of the last decade, financial liberalization had become the single most controversial policy prescription. After the currency crises in East Asia and the Russian Federation, the focus of the debate shifted from when to liberalize the capital account to whether to liberalize it at all. Rodrik (1998), for example, argues that there is no evidence in the data that countries without capital controls have grown faster, invested more or experienced lower inflation.

Significantly, Aizenman (2005) found no evidence of a "growth bonus" associated with increasing the foreign financing share. In fact, the evidence suggests just the opposite: throughout the 1990s, countries and regions with higher self-financing ratios grew significantly faster than countries and regions with lower self-financing ratios (see box VI.5). The positive and economically significant effect of self-financing ratios on real per capita GDP growth has been confirmed for 1970-2000.

Box VI.5

**Financial liberalization and growth**

There exists a large body of empirical research on financial liberalization and growth, but the results have been largely inconclusive. Nevertheless, support for the claim that financial liberalization inevitably boosts growth is slim. Kose, Prasad and Terrones (2006) have shown that capital account openness did not increase access to international finance for domestic investments. The same authors (2003) showed that capital account liberalization increased consumption volatility relative to output volatility in emerging economies. Prasad, Rajan and Subramanian (2007) also show no positive link between foreign capital and economic growth; instead, fast-growing developing countries relied less on foreign capital.

Rodrik and Subramanian (2008) argue that the case for financial globalization and capital account liberalization is based on the misguided premise that developing countries are savings-constrained and that the inflow of foreign capital eases this constraint. In their view, the unavailability of foreign capital is not a binding constraint on growth in these countries. They are much more likely to be investment-constrained, with low levels of investment resulting from low expectations of profitability and returns. Consequently, increasing access to foreign capital flows would have little positive effect on raising growth-promoting investments.

For the vast majority of countries surveyed, their investment rates fell when United States interest rates were low and external liquidity was plentiful. This should not have happened with countries that were savings-constrained. Low interest rates should raise borrowing and, with it, investment. Among the countries surveyed, the only two exceptions were China and India, which had shielded themselves from financial globalization (see Rodrik and Subramanian, 2008).

In contrast, capital account openness has seen capital flowing out of developing countries to the rich countries, especially the United States, funding its unsustainable consumption boom and asset price bubbles in recent years. Capital account liberalization has also not resulted in any significant decline in the cost of finance. Instead, the cost of finance has behaved "perversely", rising sharply during economic downturns (forcing real interest rates to rise) and falling during booms (yielding low real interest rates). Regarding the current crisis, even the World Bank (2009d, pp. 47-48) recently noted:

> Capital restrictions might be unavoidable as a last resort to prevent or mitigate the crisis effects. A few emerging countries have introduced capital controls and other measures to better monitor and, in some cases, limit the conversion of domestic currency into foreign exchange ... capital controls might need to be imposed as a last resort to help mitigate a financial crisis and stabilize macroeconomic developments.

As a result, macroeconomic policies have become pro-cyclical. For example, during the current global economic and financial crisis, private capital flows to developing countries have dropped sharply, and risk premiums for external financing have surged. Net private capital inflows to developing economies declined by more than 50 per cent during 2008, dropping from the peak of more than $1 trillion registered in 2007 to less than $500 billion. Another significant decline of 50 per cent is expected for 2009. The risk premium on lending to emerging and developing countries soared, on average, from 250 to about 800 basis points within the space of a few weeks in the third quarter of 2008.

In light of the disappointing experience, authorities should institute mechanisms to restrict large and sudden flows of short-term capital or "hot money" (Epstein, Grabel and Jomo, 2003). By employing diverse capital management techniques during the 1990s, Chile, Colombia, Taiwan Province of China, India, China, Singapore and Malaysia were able to achieve critical macroeconomic objectives. These techniques included the prevention of maturity and locational mismatches; attraction of desired foreign investments; reduction of overall financial fragility, currency risk, and speculative pressures; insulation from the contagion effects of financial crises; and enhancement of the autonomy of economic and social policy.

Finally, financial sector deregulation led to the privatization of State-owned financial institutions and, in most cases, the abandonment of specialized financial institutions established to subsidize and direct credit to small and medium-sized enterprises, agriculture and other development priorities. As a result, in many developing countries, financial deregulation has adversely affected rural banking. Unprofitable rural branches of commercial banks have closed, making access to credit more difficult for farmers and other people living in rural areas (Deraniyagala, 2003; Chowdhury, 2002; see also box VI.6). Privatization has also reduced the developmental role of Governments, result-

Box VI.6

**Financial deregulation, inequality and poverty**

Developing countries need to invest in both agriculture and manufacturing in order to diversify their economies as well as to reduce poverty through employment creation and food price stabilization. However, despite much higher social returns to agricultural and manufacturing investment, following financial sector deregulation, banks and financial institutions have increasingly financed collateralized stock market and real estate investments. Private commercial banks discriminate against employment-intensive sectors such as agriculture and small-scale enterprises owing to the higher transaction costs of lending to a larger number of small borrowers and the lack of collateralizable assets of small farmers and owners of small and medium-sized enterprises. Ghosh (2008b) maintains that "[t]he agrarian crisis in most parts of the developing world is at least partly, and often substantially, related to the decline in the access of peasant farmers to institutional finance, which is the direct result of financial liberalization".

The situation has been made worse by the closing of Government-run specialized financial institutions for agriculture and small and medium-sized enterprises as part of financial deregulation. Furthermore, previously Government-owned privatized banks have closed rural branches deemed not to be profitable, as there is no longer any requirement to ensure rural banking services. These measures have reduced credit availability for farmers and small producers, and have contributed to the rising costs of needed working capital, thereby exacerbating rural distress. In rural India, for example, there is strong evidence that the deep crisis in farming communities—resulting in farmer suicides, mass migration and even deaths from hunger—has been related to the decline of institutional credit, forcing farmers to turn to usurious private moneylenders. A study by the Inter-American Development Bank (2007) of 17 Latin American countries for the period 1977-2000 found that financial liberalization has had a significant effect on increasing inequality and poverty.

In sum, financial deregulation has undermined important social functions of finance by making it less inclusive. It has also destroyed an important industrial policy instrument historically utilized by most successful late industrializers. Most late industrializing countries, at least since the twentieth century, have created well-regulated financial markets and often State-controlled financial institutions designed to mobilize savings to support priority investments. They used directed credit policies and differential interest rates to support nascent industries with the potential to expand into export markets. They also created development banks with the mandate to provide long-term credit on attractive terms. These financial sector policies contributed significantly to rapid economic transformation and poverty declines in those countries.

ing in the poor performance of small and medium-sized enterprises and agriculture as well as deindustrialization, with adverse impacts for employment and poverty reduction.

## Privatization

The privatization of State-owned enterprises, including utilities, is another central component of adjustment policies for developing countries. Privatization is often a crucial requirement for securing aid funding, and is a key policy of the Poverty Reduction Strategy Papers (PRSPs), with the World Bank continuing to link privatization to poverty reduction.

## How can privatization reduce poverty?

The rationale for privatization is rooted in public choice theory which predicts that privatization will spur development of the private sector. Privatization is supposed to improve the efficiency of enterprises by focusing on financial performance. Through better resource allocation and improved efficiency (due to the absence of rent-seeking), privatization is expected to spur economic growth and hence reduce poverty. Proponents of privatization also project fiscal benefits, occurring from the one-time revenue gains for the government that "sells" presumably failing State-owned enterprises and is relieved of the burden of financing investment (Campbell-White and Bhatia, 1998). This phenomenon is expected to allow Governments to spend more on services for the poor.

But how does privatization actually help develop the private sector? This remains unclear. It could increase private investment in a sector, but whether this leads to output and welfare benefits will depend on competition, among other factors. It could signal government support for the private sector. However, for many developing countries (for example, countries in sub-Saharan Africa), lack of investor interest has been a common feature of privatization, with Governments offering increasing concessions to entice investors to acquire their assets—often to meet the requirements of donors and creditors (Bayliss, 2003). Privatization can also create an environment where the private sector attempts to stifle competition and flout regulations in order to enhance profits. In the absence of effective regulation, where Governments have recourse to valid sanctions against private firms, the State will be powerless to prevent market abuses. In such a situation, it is not privatization that will develop the private sector, but rather effective Government regulation.

Private firms will invest only when and where they expect to make a profitable return. Therefore, they will want to invest only in profitable activities and will not buy losing enterprises. Thus, the Government will not only be left with losing enterprises, but also lose a regular source of revenue from enterprises sold to the private sector. For example, in their study of privatization in Africa, Campbell-White and Bhatia (1998) found that the enterprises sold had not been financially draining government resources. In the case of profit-making units, the fiscal effect of privatization is almost invariably negative. If the Government sells an asset that provides an income flow (profits, etc.) equal to or greater than that based on the prevailing interest rate on Government securities, then the Government would lose a future income stream by selling it.

Additionally, if revenue from privatized enterprises becomes uncertain, firms may back out of investment projects. In Zimbabwe in 1999, the United Kingdom firm Biwater withdrew from a proposed private water project because the project's intended beneficiaries (consumers) were too poor to pay a tariff to ensure the profit margin that Biwater was seeking (Bayliss, 2002). They may also seek guarantees from Governments to ensure revenue flows rather than take the risks. In infrastructure, private companies will ensure that their investments are recouped with profit. In power generation projects, private investors often will not invest without a power purchase agreement (PPA) in place under which the publicly owned utilities agree to purchase the output of the plant at a fixed price often cited in foreign exchange for a period of 20-30 years. Such agreements can be crippling for Governments. In the case of the Enron-owned Dabhol power project in India, the terms of the power purchase agreement became so onerous for the government of Maharashtra State—owing to currency devaluation and the high cost of fuel—that it defaulted on payments (Bayliss and Hall, 2000).

There is also no clear evidence that the private sector performs better than the public sector. While private ownership may bring better management skills and incentives, this is by no means inevitable.

There are numerous examples of utility privatization failures. For example, in Puerto Rico, four years after a subsidiary of the French multinational Vivendi took over management of the water authority, its financial situation deteriorated to such a degree that the State had to provide subsidies (Bayliss, 2002). Private investment in infrastructure, for example, in a water supply programme in a developing country, is not normally a very attractive proposition because it involves a large upfront investment and a long-term pay-off. For this reason, privatization projects are often designed in such a way as to enable private firms acquiring interests in service delivery to make quick profits, leaving the longer-term, more expensive investments to the Government. For example, in Guinea and Côte d'Ivoire, private operators were given responsibility for billing consumers for water, while the Governments committed to invest in infrastructure. The fact that the private firm made a profit while the State-owned enterprise continued to accumulate losses was due not so much to the difference in ownership as to the type of business each party engaged in. Further, given the private firm's interest in increasing revenue, the focus was on installing water meters, increasing billing and bill collection, rather than on improving access to water (Brook Cowen, 1996). This can impact negatively on the poor, who have limited access to basic infrastructure.

Private firms are also sometimes guaranteed rates of return which allow for price or user charge increases. In the Plurinational State of Bolivia, the privatized water company raised prices sharply in the late 1990s to enable it to earn such rates of return, provoking widespread popular protests (Lobina, 2000). Case studies of African countries have also shown that water prices rose substantially after privatization—to the point where water became inaccessible to the poor (Magdahl and others, 2006). In addition, developing-country Governments often have weak regulatory capacity to monitor price increases by privatized firms. Whether privatization-related price hikes increase poverty will depend on the extent to which the poor are consumers in these sectors, the extent of the price increases and their ability to cope. Extensive privatization in Mongolia since the early 1990s has led to sharp price hikes in essential utilities, with negative effects on the real incomes of the poor (box VI.7; see also Nixson and Walters, 2006).

One common immediate effect of most privatizations is reduced employment. This occurs not only because there tends to be substantial overstaffing in public enterprises, but also because the new owners typically prefer to begin with fewer employees than they need in order to allow for greater flexibility. In addition, there are the linkage and multiplier effects of privatization-related changes. Employment conditions can be adversely affected in upstream and downstream activities, as well as in the local community through the indirect-demand effects of workers' incomes. A study by Van der Hoeven and Sziráczki (1998) showed that utility privatization in developing countries has significant employment-reducing effects, sometimes impacting up to 50 per cent of the workforce.

A study by Macarov (2003) on the effects on the poor of cutbacks in government spending in areas such as medical services, education and social welfare found that they often resulted in the formation of a system with two tiers, one for the rich and the other for the poor. After reviewing the distributional impact of privatization activities involving utilities in a wide range of developing economies, principally in Africa and Latin America, Bayliss (2002) con-

Box VI.7
**Privatization in Mongolia**

Privatization has been a major part of Mongolia's transition to capitalism. Its move to a market economy has been accompanied by increases in poverty and income inequality. More than 10 years after it began its transition, Mongolia remains one of the poorest countries in the world.

Privatization continues to be a central part of economic reform in Mongolia, as in other transition economies. The goal has been to increase private sector participation in the economy, to which successive Governments have remained committed. Previously, Mongolia's economy had been narrowly based on the export of copper, cashmere wool and gold, as well as on a large amount of donor aid from the former Soviet Union. In 1991, after the collapse of the Soviet Union and the demise of its trading arrangements, privatization in Mongolia exemplified a "shock therapy" approach to transition. The overall effect was a significant decline in standards of living, with dramatic rises, in the early period of transition, in levels of poverty and inequality, which have remained at very high levels.

The Government, which owned 75 per cent of all property, adopted a voucher system of privatization. In the first phase, each person was issued three red vouchers which could be used to buy shares in small State and cooperative businesses. Shortly afterwards, each person was issued one blue voucher, with which he or she could bid for ownership of the larger State enterprises. Mongolia's Stock Exchange was also established to allow trading in shares.

Privatization was undertaken without any analysis or consideration of the impact on poverty and income distribution. In an evaluation of this experience, Nixson and Walters (2006) found that privatization had affected poverty adversely in Mongolia by 2000. They also concluded that, among other consequences, the Government had ignored the role of agencies that provided poor people with collective goods and services; reduced available livelihood options, making poorer families more vulnerable to economic shocks; and allowed utility prices and service charges to be increased after privatization.

cluded that privatization had demonstrably harmed the poor, either through loss of employment and income, or through exclusion from, or reduced access to, basic services, as the result of private firms' principal concern with profits, prices and costs. At the same time, weak governance and regulatory capacity in many developing countries led to poor control of market abuses by private utility companies.

## The way forward

The empirical evidence derived from the outcomes of economic liberalization indicates that excessive reliance on markets and the private sector carries high risks. The World Bank (2005, p. 133) has noted:

> There are many possible ways to open an economy. The challenge for policymakers is to identify which best suits their country's political economy, institutional constraints, and initial conditions. As these vary from country to country, it is not surprising that there is a striking heterogeneity in country experiences regarding the timing and pace of reforms.

A much more nuanced approach, based on lessons from history, is needed. Clearly, economic growth and structural change are necessary for sustained poverty reduction. Wholesale trade liberalization, however, is not the best strategy for this. To enhance the poverty-reducing effects of growth and structural change, the economic transformation process must challenge inequality and the exclusion of poor and disadvantaged groups. For sustained reductions in poverty, the focus should also extend to productivity growth and employment creation. Developing countries should therefore consider, selectively, the formulation of trade and industry policies to augment the development of new potentially viable production capacities and capabilities.

Not only should financial policy in developing countries be concerned with ensuring financial stability, but it must also be counter-cyclical, developmental and inclusive. In many developing countries, this will require explicitly addressing the needs of food agriculture through rural banking and other inclusive finance initiatives. Governments should consider reintroducing specialized development banks, especially to promote employment-intensive small and medium-sized enterprises and agriculture. This may involve directed and subsidized credit as well as other proactive financial policy initiatives. Undoubtedly, directed credit programmes create "distortions" in the financial market and may be vulnerable to rent-seeking. However, the possible cost of such distortions must be weighed against the "cost" of financial market imperfections that discriminate against small borrowers.[7]

7 Beginning in 1984, Ecuador had eliminated or scaled down directed credit programmes and removed administrative controls on interest rates as part of financial sector liberalization programmes. Since then, the supply of credit has declined drastically, with the contraction of Government-provided loanable funds, and reached a figure as low as 9 per cent

Private commercial banks can be compelled to comply with requirements to serve rural and other disadvantaged regions, agriculture and small and medium-sized enterprises as well as disadvantaged social groups. Governments can consider a range of policy options and instruments needed to achieve such objectives. For example, in India, all banks (public and private) are required to lend at least 40 per cent of net credit to "priority sectors". If banks fail to meet this requirement, they are instead obligated to lend money to specified Government agencies at very low interest rates.[8]

Alternatively, the central banks can combine India's type of penalties for failure with incentives, such as asset-based reserve requirements, support for pooling and underwriting small loans, and support of employment-generating investments through use of the discount window. Asset-based reserve requirements can be an effective tool for creating incentives for banks to invest in socially productive assets (see Pollin, 1998; Epstein, 2002). Also, based on known employment elasticities, the central banks could list a set of employment-generating investments; lower reserve requirements would then apply for loans for such investments than for speculation or for buying stocks and shares.

Central banks can also take steps to create liquidity and risk-sharing institutions for loans to small businesses that show promise for generating employment but that do not have adequate access to the credit market. For example, central banks can provide financial and administrative support for asset-backed securities, through which loans would be made to small businesses and other employment-intensive activities, bundle these investments, and then sell them as securities on the open market. Finally, central banks can open a special discount window facility to offer credit, guarantee or discount facilities to institutions that on-lend to firms and cooperatives engaged in employment-intensive activities.

After the uncritical and often blind embrace of privatization during the 1980s and 1990s, a more cautious, if not critical, approach has emerged in recent years for at least two reasons (Bayliss and Fine, 2007). First, the revenue flows from State-owned enterprises are essential for maintaining and enhanc-

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of GDP in 1990. The firm-level debt structure data show that, together with the decline in total credit, the share of long-term loans as a share of total debt fell from 12 per cent in the early 1980s to 8 per cent in 1992. The growth rate of real long-term credit was negative for most years. The firm-level data also show that the percentage of directed credit was much higher for longer-term maturities prior to liberalization reforms. This proportion of directed long-term credit relative to total long-term credit declined from 59.3 per cent in 1985 to 35.9 per cent in 1990. The proportion of directed short-term credit relative to total short-term credit declined from 31.1 per cent in 1985 to 3.3 per cent in 1992. The decline in the access to long-term credit negatively affected firms' performance, especially in terms of productivity. In particular, the lack of access to long-term credit adversely affected firms' ability to acquire improved technology (see Schiantarelli and Jaramillo (1996)).

8 Studies by Banerjee and Duflo (2004) found that most banks complied with the regulation and the programme contributed significantly to the expansion of agriculture and small-scale industries.

ing Governments' fiscal space. Second, State-owned enterprises can be important instruments for poverty reduction efforts.

The performance of State-owned enterprises should not be evaluated solely based on bookkeeping "bottom lines", as they often have other objectives, such as employment creation or social protection. Employment in State-owned enterprises may represent a better way of providing social security than social security payments themselves from the point of view of self-esteem, learning by doing and reciprocal obligations. Privatization must not ignore employment conditions and likely job losses, as they affect poverty, especially of the working poor. There should be adequate protection of employment conditions as well as active labour-market programmes in place. Similarly, provision of utilities must remain inclusive regardless of ownership. Public utilities, if privatized, must stipulate mandatory adequate service provisions to disadvantaged groups and areas.