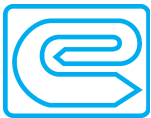


EXIM BANK: RESEARCH BRIEF

Financial Liberalization and its Distributional Consequences



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In commemoration of Jawaharlal Nehru Birth Centenary (1889 – 1989), Export-Import Bank of India instituted the International Economic Development Research Annual (IEDRA) Award in 1989. The objective of the award is to promote research in international economics, trade and development and related financing, by Indian nationals at universities and academic institutions in India and abroad. The study titled '*Financial Liberalization and its Distributional Consequences: An Empirical Exploration*' is based on the IEDRA Award 2007 winning thesis by Dr. Arjun Jayadev.

The Context

This study has done an empirical exploration of the distributional impacts of external and domestic financial liberalization using a cross-country analysis and case studies on two developing countries, namely, India and Indonesia. Despite an abundant literature that evaluates the various social consequences of neo-liberal reforms, the effects of financial deregulation on various elements of distribution have not been thoroughly analysed. Many reasons could be attributed to this gap, including non-availability of comparable data on inequality.

The recent developments in the world, and advances in research have made this gap more evident and the urgency to address. A series of 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 evidences 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. As a result, there has been a significant reversal in the commitment to financial deregulation and growing concerns about its effects on social outcomes.

This study attempts to make an empirical contribution to this literature by adopting a two pronged methodology: (i) a cross country analysis of a particular question raised by the theoretical literature, and (ii) two case studies of developing countries designed to make a detailed assessment of the distributional consequences of financial reforms.

A significant issue within the political economy of globalization relates to the distributional consequences of the increased mobility of capital vis-à-vis labour. In the last few years, a common story has developed around this process. A brief précis of this narrative, found both

in the literature and academic circle, illustrates that in an environment of increased global competition and capital mobility, rents and quasi rents in production are significantly squeezed. However, in such a world, share of capital in these reduced rents is decisively increased, since the capital is increasingly seeking higher returns from abroad, more easily than before, thus enhancing its position in a strategic bargain with labour.

There have also been few attempts to test the effects of openness to capital flows on the share of income going to labour at the economy-wide level. Much attention has been focused on the effects of trade integration on wage outcomes; but in 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, and there have been some empirically oriented microeconomic studies focused on the issue in the context of US unions. The implications for macro level outcomes, however, remain unstudied. Yet, at the same time, macroeconomists have documented large reductions in the labour share of national income in a few countries over the last two decades; the era – perhaps not coincidentally – of major increases in capital mobility among other changes. This is an important connection since many of the accounts of globalization appear to center on the impacts of capital

mobility on the bargaining power of labour as a whole, and hence on macroeconomic outcomes. The question that may arise would be whether the hypothesis that capital account openness reduces the share of income going to labour has any empirical traction at the macroeconomic level?

A related question that may arise would be how generalizable such a claim is. The bargaining argument in the literature 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 unions, the organized sector is large, and tacit agreements and political accords between capital and labour as a whole often prevail. By contrast, middle and low income countries possess significantly different labour market conditions. In countries with per capita income even as high as US \$ 2,000 to US \$ 5,000, social security and unemployment benefits are insignificant. Employment in the unorganized sector is large especially in developing countries like India; current estimates suggest that informal employment comprises about one-half to three-quarters of non-agricultural employment in developing countries. 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.

Data and Methodology

This study 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 attempt made in

this paper is the use of a new and more nuanced index of capital account mobility. 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 data on capital restrictions, the study employs an index developed by Lee and Jayadev, 2005, which solves some of the extant problems with the data. The United Nations' National Accounts Statistics database is used to extract a common cross country measure of the labour 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 labour 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 inappropriate and unsatisfactory, across both developed and developing countries. In addition, the effects of openness on labour outcomes are likely to vary by the level of development. To account for this, the estimation equations are also estimated separately for the low-income, middle income and upper income groups of countries.

Findings from Empirical Analysis

The empirical results suggest that the effects of capital account openness on distributional outcomes are significant, robust, and therefore merit serious attention. Overall, capital account openness is an important correlate of the observed decline in labour 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 labour 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 capital accounts has the strongest negative impact on the share of labour in developed countries. Middle-income countries as a whole also tend to see a negative correlation between share of labour and capital account openness. For the poorest countries, however, the empirical analysis undertaken by the study did not provide evidence to suggest that the bargaining channel plays a central role in explaining falling share of labour. Structural differences between countries clearly remain important in outcomes for labour. Finally, the negative correlation between openness and the share of labour persists through the medium term in the overall country sample.

Case Studies

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. Cross-country analyses cannot, almost by definition, take this into account, and have come into some criticism for this. To this end, the study 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 in identifying subtler structural or longer-term impacts of the changing political, rural-urban and state-market relationships following liberalization. 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 and to assist countries move up the productivity chain. 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.

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 an examination of simple descriptive statistics.

India

In March 1991, following a severe crisis emanating from the external sector, the Indian Government embarked on a series of reforms meant to turnaround the Indian economy with a more liberalized system. Since then, various liberalization measures undertaken by successive Governments have brought wide-ranging changes in all segments of the economy, including the internal and external financial liberalization.

While there have been debates and discussions on the various consequences of reforms, be it on the economic outcomes or social outcomes, very little efforts were taken to address the distributional consequences of financial liberalization in the Indian economy as a whole.

Thus, this study has examined a small subset of issues – namely, the impact of banking deregulation and its relationship to access to finance and balanced development. The analysis suggests the following key points:

- ❖ 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.
- ❖ Banking sector reforms have improved the balance sheets of banks, since the early 1990s.
- ❖ 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 some elements of rural deprivation and distress.

By most accounts, one of the most encouraging results of reforms was the restoration of the profitability of the banking sector and general increase in the levels of efficiency therein. While there are debates as to which sub section of the banking sector - public or private sector banks - has been most profitable, it remains the case that the threat of non-performing assets has receded. It may also be possible that such improvements might have come at the expense of those who were protected during the period of social banking: the rural and urban poor.

Overall, the story of finance in the age of reforms in India suggests 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 vulnerable sections in 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

favoured alternative sources of finance to bridge this gap in a sustainable manner.

Indonesia

Modern Indonesian economic history often starts with the installation of the 'New Order' regime in 1965. The era has brought-in three decades of political stability and rapid economic growth. During this period, however, an unexpected and devastating financial crisis occurred in 1997. Therefore, it is important to analyze the history of the regulatory financial structures in Indonesia and the ways in which it dovetailed with national developmental goals. Much like in the case of India, 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 controls 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.

The purpose of the case study 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. The analysis considers the effects of financial deregulation from the mid 1980s and the devastating financial crisis on aspects of inequality within the country.

The Indonesian case study makes the following central points:

- ❖ 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. 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.

- ❖ 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.
- ❖ A direct consequence of reforms was an explosion in private sector financial intermediation, without prudential regulations.
- ❖ The run up in the stock market has resulted in gains for a very small proportion of Indonesians.
- ❖ A boom and bust cycle followed the financial liberalization with massive capital inflows and with 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.
- ❖ Following the crisis, the government has absorbed the cost of the bailout and as a result, has seen a serious fiscal squeeze.

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 makers 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.

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. As a result, poverty reduction and egalitarian growth have had to take the back seat for the immediate period.

Conclusion

While capital account 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 study, 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 can help clarify the ways in which capital account regulations can help or hinder in this process.

Second, despite the inefficiencies in a state directed financial apparatus, such as that existed in India in the 1980s, and in Indonesia in the 1970s, they channeled resources to the urban and rural poor. The impact of liberalization has strengthened the 'third way'-civil-society-based micro-credit-mechanisms, which may not be adequately prevalent to handle the large requirements from population that are outside the formal credit system. Thus, there may still be a role for the state to play in poorer economies.

This study has made a beginning to simply account for and trace the distributional consequences of a liberal financial regime. The case study analyses raise several questions such as:

- ❖ 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 in a way to promote the much needed public expenditure?
- ❖ In what ways does the explosion of credit availability at the upper ends of the income distribution impact social outcomes?

Many more such questions are expected to be answered 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 inclusive growth.

The contents of the publication are based on information available with Export-Import Bank of India and primary desk research through published information of various agencies. Due care has been taken to ensure that the information provided in the publication is correct. However, Export-Import Bank of India accepts no responsibility for the authenticity, accuracy or completeness of such information.

Note: Indian Rupee are referred in crore and lakhs:
 1 crore : 10 million
 1 lakh : 100 thousand

Publication is available with:
 Dharmendra Sachan
 Chief Knowledge Officer
 EXPORT-IMPORT BANK OF INDIA
 Centre One Building, Floor 21,
 World Trade Centre Complex,
 Cuffe Parade, Mumbai - 400 005, India.
 Phone : +91 22 2218 0379
 Fax : +91 22 2218 3070
 E-mail : dharmendra@eximbankindia.in
 Website : www.eximbankindia.in

Contact Numbers : Ahmedabad : 2657 6852, Bangalore : 2558 5755, Chennai : 2522 4714, Guwahati : 246 2951, Hyderabad : 2330 7816, Kolkata : 2283 3419, Mumbai : 2282 3320, New Delhi : 2332 6625, Pune : 2645 8599
 Dakar : (221) 338232849, Dubai : (971) 43637462, Johannesburg : (2711) 442 8010, London : (44) 2073538830, Singapore : (65) 653 26464, Washington D.C. : (1) 2022233238