
Financial liberalization and the geography of poverty

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We investigate the possibility of further channels through which financial liberalization policies might affect poverty and discuss how various factors have produced varying outcomes in different countries. The growth channel is the only one widely accepted in the literature. We suggest that three further channels should be added to the list: the financial crises channel, the access to credit and financial services channel and the income share of labour channel. We discuss how these channels operate differently in different countries. As far as we know, no attempt has been made previously in the literature to go beyond the growth channel.

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Introduction

Liberalization of cross-border financial flows and growing integration of capital markets has become commonplace since the 1980s. The period since then has also been one of remarkable economic growth along with a number of financial crises and continuing poverty in many parts of the world. There are still millions of people living in extreme poverty, mostly in Asia and Africa. Is there a potential for the increasing integration of capital markets to solve the most urgent problem of mankind, namely, providing each world citizen with safe access to food, clothing, shelter, as well as education and health services? What do the experiences of different countries with financial liberalization (FL) tell us regarding the poverty-reducing effects of these policies in different settings? What does theory tell us about the role of FL in the elimination

of poverty? In assessing the effects of these policies on poverty, what channels of interaction should we investigate? The aim of this paper is to provide answers to these questions.

Developing countries have had very different experiences regarding FL, growth and poverty. Countries such as China and India experienced large reductions in poverty and high growth rates with relatively restricted capital accounts. On the other hand, fast-growing East Asian countries with open capital accounts were hit by the South East Asian crisis of 1997. In 1998, the number of people living in poverty in the four countries that were hit the hardest by that crisis increased by more than 60%. The estimates for the increase in poverty are 17 million in Indonesia, 2.3 million in Thailand, 665,000 in the Philippines and 500,000 in Malaysia (Charlton and Stiglitz, 2004; World Bank, 2007).¹

Based on the experiences of various countries, we can say undoubtedly that the same policies can have very different effects on poverty reduction in different countries. The direction and the magnitude of the full effect of FL can be judged only by looking at the various channels of interaction between FL and poverty.

One channel of interaction between FL and poverty is the growth channel. Related literature has been, to a great extent, based on the view that FL mobilizes savings and allocates capital to more productive uses, both of which help increase the amount of physical capital and its productivity. The trickle-down effect of economic growth caused, or accompanied, by FL increases incomes, reduces poverty and improves income distribution. However, one would expect the economic and institutional changes brought about by FL to have a more complex effect on the living conditions of the poor. We suggest that three further channels should be investigated: the financial crises channel, the access to credit and financial services channel and the income share of labour channel. As far as we know, no attempt has been made previously in the literature to go beyond the 'growth channel'. Thus, the originality of this contribution is to make the case of these extra three channels, explain them, comment on their significance and to examine the cross-country variation in the effects of these channels.

To supplement the analysis of theoretical links between FL policies and poverty, this contribution looks closely at the empirical evidence on each theoretical link. Apparently, there is still no clear understanding of how the mechanisms involved in FL influence different segments of the population and, in particular, the poor. Furthermore, a straightforward application of the standard policies without taking any precautions to protect the disadvantaged groups from potential losses worsens the living conditions of these groups. We proceed in the next section to draw lessons from relevant experiences of various countries. The paper then examines the economic growth channel that is well known in the literature. The rest of the paper puts together three further channels through which FL can affect pov-

erty. The fourth section visits the financial crises channel, and is followed by a section that considers the access to credit and financial services channel. The paper then discusses the income share of labour channel. The final section summarizes and concludes.²

Lessons from Various Countries

While the purpose of this contribution is the identification of further channels through which FL might affect poverty, an interesting and related aspect of this exercise is the geographical or spatial dimension. It is in fact the case that developing countries have had very different experiences regarding FL, growth and poverty from developed countries. In this sense, it would be interesting to identify the factors that might determine the spatial variation in the FL-poverty relation, given the four channels whereby this relationship is made operational, before we examine how these factors may have produced different outcomes in different regions due to structural differences. We undertake this exercise by identifying such factors, followed by an examination of these factors in the case of China, India and Sub-Saharan African countries. In view of space limitations, we highlight one particular set of factors, which we argue is of paramount importance when spatial variation is the issue. This set comprises of a number of varied characteristics, which can be summarized as social, economic, political and more generally institutional characteristics of the geographical regions in question.

In the rest of this section, we discuss briefly the experiences of the developing countries mentioned above with FL and poverty. Since the 1980s, absolute poverty declined globally, but not in every region. A large share of the world's poor still live in China (211.6 million people in 2001, based on the \$1 a day measure) and India (358.6 million people in 2001, based on the \$1 a day measure), despite large reductions in poverty that have been achieved by these countries in recent years (Chen and Ravallion, 2004). The highest poverty rates and the greatest depth of poverty in the world are in Sub-Saharan Africa. Headcount poverty rates are

rising in Nigeria, South Africa and Tanzania (World Bank, 2006). These observations lead us to focus our discussion on these cases.

There is the famous debate on whether 'gradualism' or 'shock therapy' in liberalization is more desirable. The Chinese experience is contrasted with the experiences of the former Soviet Union (FSU) and Eastern European countries in the 1990s and is thought to demonstrate the merit of gradualism or experimentation to top-down reform. In the formerly socialist countries, starting with the reforms in the late 1980s, the period of collapse of Communism and the transition to capitalism was a period of broadening set of opportunities and increasing availability of better quality consumption goods. But it was also a period of large declines in income, increasing unemployment, rising poverty and suicide rates and great uncertainty.

Unlike the one-shot reform strategy followed by the FSU and Eastern European countries, Chinese reforms, launched in the late 1970s, have been gradual, with varying speed since the beginning. The first wave of liberalization included agricultural liberalization where use rights to commune land were allocated among rural households. By 1984, all provinces had adopted these reforms. Encouraged by this success, Chinese leaders began to permit rural enterprises and to implement market-oriented reforms in the urban areas as the second wave of liberalization (Lipton and Zhang, 2007). The fast growth of rural enterprises and the urban non-state sector raised employment and the share of wages in income by following China's comparative advantage and making labour intensive technology choices.

As the third wave of liberalization, China began to reform its foreign trade management system. Private sector firms were given more self-management power and the permission to keep some foreign exchange. Mandatory planning was gradually lifted while special economic zones were built in coastal provinces. By the beginning of 1990s, China had integrated into the world economy by allowing foreign capital inflows, and especially foreign direct investment (FDI), which makes up more than 70% of capital inflows. While in the 1979–1984 period the total gross FDI inflow was only \$3.06 billion, in

2002 alone it was \$52.7 billion (Lipton and Zhang, 2007).

The performance of the Chinese economy has been remarkable. Between 1978 and 2003, gross domestic product (GDP) per capita grew 8% annually. There have been major structural changes and urbanization during the period as the share of agriculture in GDP fell from 28 to 14% while its share in employment fell from 70 to 49%. Based on the \$1 per day poverty line (1993 purchasing power), the poverty rate declined from 62% in 1980 to 16.6% in 2001 and to 8% in 2003 (Lipton and Zhang, 2007). Along with the decline in poverty, education and health indicators have improved. Despite the remarkable progress, however, poverty in China is far from eliminated. There are still 75 million rural people below the dollar-a-day poverty line (Lipton and Zhang, 2007). Important for our analysis, the substantial part of the decline in poverty had already happened by the mid-1980s, before the big strides in foreign trade or investment liberalization (Bardhan, 2006). As the poverty rate falls to a certain level, it becomes more difficult to help the remaining poor to escape poverty. The problem with China is that poverty reduction has been uneven across provinces. The poorest are mostly in remote, resource deficient regions. These people have high population growth rates and low literacy rates with little hope for successful migration. The existence of regional disparities in China is similar to the continuation of deprivation in East-Central India, despite overall advances in poverty reduction. In both countries, 'regions with worse health and education outcomes not only have fewer specialists and facilities but also attract lower quality personnel, supervision, popular participation and public responsiveness and perhaps governance' (Lipton and Zhang, 2007, 20). FDI in China has helped reduce poverty by being export oriented and by following the country's comparative advantage in labour-intensive technologies. However at present, most FDI concentrates in coastal provinces and manufacturing sectors. The occupations and provinces of the poor receive much smaller shares of FDI than their shares in the population (UNCTAD, 2003).

On the gradualism debate, Sachs and Woo (1994) state that it was not gradualism but China's economic structure that facilitated success. China began reform as a peasant agricultural society, whereas the FSU countries as urban and over-industrialized. China faced the classic problem of transferring workers from low-productivity agriculture to high-productivity industry, an easier problem to solve. On the other hand, in FSU, the problem was structural adjustment: cutting employment in inefficient and subsidized industry to allow new jobs in efficient industry and services. However, the speed of reforms is not a trivial issue. One needs to keep in mind that it took about 40 years for European countries to attain the level of liberalization now being sought in developing economies.

India is also known as a country that was slow to adopt FL (Jha, 2002). The 'Delhi Consensus' avoided capital account liberalization until recently. Liberalization efforts in this country were at a creeping stage in the 1980s. The country experienced a balance of payments crisis in 1990–1991, resulting in it being subjected to an International Monetary Fund-style adjustment programme, reminiscent of the notorious 'Washington Consensus'. Starting in 1991, economic reforms accelerated (Chandrasekhar and Pal, 2006). The flows through foreign institutional investors were relatively stable during the 1992–2002 period, but have recorded an extraordinary surge since 2003. The stock market index, the Bombay Sensex, has risen during the same period and is more volatile than before. A high average growth rate during the later period put India among the fastest growing developing countries in the 1990s (Ahluwalia, 2002). The share of services in national income increased fast.

Parallel to these developments was a sharp rise in rural, urban and regional inequality and only a marginal decline in Indian poverty in the post-reform period. The rise in inequality was due to an increase in the income share of capital relative to labour, a drop in the rate of labour absorption and the rapid growth of the services sector (Jha, 2002). It has been argued that the rise in inequality has diminished the poverty-reducing effects of higher growth. One challenge offered by FL in developing countries

like India is the rise in returns to financial activity. As long as the returns to agriculture and manufacturing are limited, there is a limit to what would be paid to finance such investment. Thus, despite the fact that social returns to such investment are higher than that for stocks and real estate, and despite the contribution that such investment can make to growth and poverty alleviation, credit may not be available at the required rate (Chandrasekhar and Pal, 2006).

Sub-Saharan African countries, where headcount poverty rates (according to the frugal \$1 a day threshold) vary around 45%, faced stagnating growth in the early 1980s. During the 1980s, per capita GDP declined by 1.3% per year, which was 5 percentage points lower than the average for all low-income countries (Collier and Gunning, 1999). It became necessary to reform and restructure these economies. The financial sector received a major part of this attention along with infrastructure. These countries implemented FL programmes in the mid-1980s to mid-1990s with the aim of mobilizing resources and relieving savings and foreign exchange constraints on growth and poverty reduction. Evidence collected so far shows that FL improved financial deepening (as measured by liquidity ratio or private sector credit ratio) to some extent; however, the link to growth via financial deepening is not as positively confirmed. Neither savings nor investments have demonstrated clear upward trends. Furthermore, growth has been quite modest and not sufficient to sustain an increase in per capita income (Serieux, 2008).

Analyses of the major factors that explain African stagnation reveal that a lack of openness in product markets, a lack of social capital, high systemic risk and poor public services are important determinants of poor growth performance (Collier and Gunning, 1999). On the other hand, the lack of formal finance is found to have a minor effect on growth, yet a more important effect at the household level. Put succinctly, 'Africa stagnated because governments were captured by narrow elite that undermined markets and used public services to deliver employment patronage. These policies reduced the returns on assets and increased the already high risks agents faced. To cope, private agents moved both financial

and human capital abroad and diverted their social capital into risk-reduction and risk-bearing mechanisms' (op. cit., 100). It is incredible that despite being highly indebted, many Sub-Saharan African countries are actually net creditors vis-à-vis the rest of the world. The external assets of these countries belong to a small number of wealthy individuals while debt is borne by the entire population via their governments (Boyce and Ndikumana, 2001).

In fact, global savings are severely misallocated. In recent years, the USA has been using a large share of the world's savings originating from relatively poor or middle-income countries (Epstein and Grabel, 2007). This process is accentuated by the international imbalances built up over a decade or more. The rise of China and the decline of investment in many parts of Asia following the 1997 crisis created a great deal of savings. These savings were eventually channelled mainly into the USA, helping to put downward pressure on US interest rates, which along with the Fed's low interest rate policy pursued at the same time, enabled households there to live well beyond their means. Low interest rates at the same time helped to push up asset prices, especially house prices, thereby enabling the financial sector to explode; the explosion of the banking sector enabled lending to households and businesses to expand substantially along with lending to other banks; all these imbalances created a more buoyant market for financial institutions. Under these conditions, one should not expect much benefit from liberalization per se.

Another important point is that financial instability exacerbates poverty thereby increasing vulnerability to conflict. Repeated conflict in developing countries creates financial strains with the elite, who often control financial systems and state banking, thereby enhancing corruption, cronyism and financial instability, which further exacerbate economic inequality and poverty (Baddeley, 2008). It follows that to the extent that FL creates financial instability in the system, as the experience since the early 1970s suggests, it can exacerbate poverty rather than reduce it.

It is clear from all these discussions that FL is neither a necessary nor a sufficient condition for

growth and poverty reduction.³ FL policies brought developing countries varying degrees of success. The outcome in each country is a function of the social, economic, political and institutional environment in the country. Therefore, financial sector reforms should at best be guided according to the specific circumstances of each country.

A further implication of our analysis of the geography of finance is that the relationship between FL policies and poverty is a complex one. As such it is not amenable to generalizations. The relationship needs to account for country-specific circumstances and institutional characteristics as a starting point. Ultimately, it is paramount to see FL policies not merely as an isolated objective but as part of a broader package of reformed measures and supportive economic policies. This is a particularly important conclusion in view of a number of major economies, like China and India, where steps are taken to liberalize their capital accounts in particular. The stakes of these policy decisions are particularly high in view of the string of damaging effects of the financial crises in the late 1980s in Latin America and in the 1990s in Mexico and South East Asian countries (see, for example, Arestis and Glickman, 2002; Kose et al., 2009). It is, thus, important in this respect to be absolutely clear on the potential channels through which FL policies might conceivably affect poverty. This is the purpose of the rest of this contribution, where we turn our attention to these channels, beginning with the economic growth channel.

Economic Growth Channel

This channel relies heavily on the FL theory as developed originally by McKinnon (1973) and Shaw (1973), whereby FL enhances savings, which supports a higher volume of investment and, thus, growth. One aspect of the channel that has not been emphasized in the literature is that the existence and strength of the link between FL and poverty depends on the existence and strength of the links between, first, FL and growth and, second, between growth and poverty. We examine both links in what follows and show that there are problems associated with the soundness of both of them.

The FL and Economic Growth Link

In FL theory, removing interest rate ceilings increases saving since saving is an increasing function of the real rate of interest by assumption. As the low-yielding projects are no longer funded, the average return to investment increases, leading to increased output (McKinnon, 1973; Shaw, 1973). Liberalizations of the stock market and the capital account, the other two dimensions of FL, are also thought to have positive effects on economic growth. Stock markets can promote long-run growth through encouraging corporate control and acquisition and dissemination of information and through mobilizing savings. Capital account liberalization may increase economic growth through higher investment as capital flows in to earn higher returns; by lowering the cost of capital via improved risk allocation; through investment in high-risk/high-return projects via global diversification of risk; through increased efficiency and productivity via transfer of technology and managerial know-how; through increasing incentives for improving the regulatory and supervisory framework for banking, by letting foreign banks introduce a variety of new financial instruments and techniques or by increasing competition and through the ‘discipline effect’ by forcing governments to pursue better macroeconomic policies (for full details and further references, see Arestis and Caner, 2005). The discipline effect, however, cannot be said to have much empirical backing simply because behaviour in international capital markets is characterized by ‘mood swings’, which have little to do with fundamentals (Arestis and Glickman, 2002).

It is just as possible that FL policies have a negative impact on growth. Stock market liberalization can lead to greater liquidity and lower uncertainty, which may reduce saving rates; also, highly liquid stock markets may act as ‘disincentive to exert corporate control’. Capital account liberalization can slow down growth by eliminating country-specific income risk and the impact of this risk on saving. Furthermore, the critical assumption that savings increase after FL does not always hold (for details and references, see Arestis and Caner, 2005.). In

fact, in countries where a large share of households has incomes close to subsistence level, we should not expect savings to be sensitive to real interest rate. Further critique emphasizes the microeconomic failures that are prevalent in financial markets. The seminal work by Stiglitz and Weiss (1981) revealed that information failures in loan markets may lead to credit rationing by banks. According to this imperfect information view, a free interest rate regime alone may not be sufficient for allocative efficiency of capital.

The empirical evidence on the relationship between FL and growth is mixed and inconclusive. Although a sizable literature finds that financial sector development is positively associated with economic growth, many studies disagree and show that the effect depends on the specific situation (for details, see Arestis and Caner, 2005.). The experiences of numerous countries reveal that FL is neither a necessary nor a sufficient condition for achieving a high growth rate. Indeed, there may be ‘reverse causation’, i.e. faster growing economies may be more likely to choose to liberalize their economies, rather than FL causing economic growth (Arestis and Demetriades, 1997).

One reason for the ambiguity in empirical results is the difficulty of identifying country-specific or region-specific effects in cross-country regressions. The balance of evidence tells us that FL does not have a close association with faster growth, let alone a causality, in developing countries, which suggests that financial constraint is not the main barrier to growth in these countries. But there is a positive effect in industrialized countries. Therefore, if a threshold effect exists, when to liberalize is a more important question than whether to liberalize (Prasad and Rajan, 2008).

Economic Growth and Poverty

In economic growth ‘the extent of poverty reduction depends on how the distribution of income changes with growth and on initial inequalities in income, assets and access to opportunities that allow poor people to share in growth’ (World Bank, 2001, 52). Economic growth can benefit the poor in two ways. Either directly, when growth favours the

sectors and regions where the poor exist and the factors of production that the poor own, or indirectly, through redistributive policies that involve using increased fiscal resources in the expansion of investments in the assets of the poor or transfers and safety nets for the poor.

Empirical evidence on the relationship between economic growth and poverty suggests that as countries get richer, on average the incidence of income poverty falls. Furthermore, the poor in developing countries share in the gains from aggregate expansion and in the losses from aggregate contraction (Beck et al., 2007b; Ravallion, 2001; World Bank, 2001). Dollar and Kraay (2002) find that the growth elasticity of the mean income of the bottom quintile is practically equal to one and that some determinants of growth, such as good rule of law, openness to international trade and developed financial markets benefit the poorest fifth of society as much as everyone else. However, a recent study by Foster and Szekely (2008) challenges these results by arguing that the elasticities are not uniformly one or greater; indeed, for the most bottom-sensitive income standards, they are not significantly different from zero. The authors state that ‘this raises doubts about the ability of growth to improve poorer incomes and suggests a role for policies that specifically address distributional concerns’.

In fact, it can be shown that the extent of a country’s poverty reduction depends on the growth elasticity of poverty, inequality elasticity of poverty and the inequality elasticity of growth. The first two factors depend on the country’s initial level of economic development and inequality (Kakwani et al., 2003). The third factor indicates whether growth is accompanied by a rising or falling inequality. How this changes with growth depends on the initial conditions and policies that each country follows. Therefore, the same growth rate can easily have different poverty reduction effects in different countries. For example, both Korea and Thailand had high economic growth in the 1990s before the South East Asian crisis. Nevertheless, the Korean economic growth generated proportionally more benefits to the poor than to the non-poor, whereas the Thai economic growth benefited the non-poor

proportionately more than the poor. There are visible differences between these two countries in inequality and the policies followed. In Korea, income is more equally distributed than in Thailand. In Korea, in 1998–1999, the ultra-poor were protected by the many welfare programs introduced by the government in response to the crisis.

Some attempts to measure the effects of FL on poverty econometrically have been based on the assumption that there is only an indirect effect via growth, i.e. the trickle-down effect (see for example Jalilian and Kirkpatrick, 2002). A noteworthy study that attempts to link FL and poverty econometrically in a direct way is the one by Honohan (2004). It concludes that ‘a ten percentage point (increase)⁴ in the ratio of private credit to GDP should (even in the same mean income level) reduce poverty ratios by 2.5 to 3 percentage points’ (10). However, the author warns that the analysis is too aggregative to be fully convincing and that the measures of financial development are weak.

Another attempt to measure the direct effect is the study by Beck et al. (2007b; see, also, Demirgüç-Kunt and Levine, 2008). It is shown by these authors that financial development through its impact on the formal financial system affects the poor disproportionately.⁵ In Demirgüç-Kunt and Levine (2008), however, it is conceded that these results are not definitive for problems prevail. The authors suggest that the ‘measure of financial development is not closely tied to theory. The study does not examine policy; rather, it examines a proxy for overall financial development that reflects many factors’ (11).⁶ In a more recent study, Arestis and Caner (2008) find no statistically significant effect of capital account liberalization on poverty in developing countries, controlling for the possible growth effect. These authors use cross-country and panel data analyses and a *de jure* measure of capital account openness (a policy variable unlike the previously mentioned studies). One problem with cross-country regressions, however, is the heterogeneity of coefficients across countries and the possibility of cross-section estimates not corresponding to country-specific estimates (for more details, see Luintel et al., 2008).

Clearly, there is no agreement among economists on the existence and strength of the links described in this section. That FL brings economic growth is a strong assumption in many cases. The growth and poverty reduction effects of FL depend on the initial level of development and on the distributional changes induced by growth as well as the set of institutions and policies that accompany liberalization.

The Financial Crises Channel

As many countries experienced high growth rates along with substantial increase in financial fragility during the 1980s and 1990s in the aftermath of pursuing FL policies, the positive view about FL in the tradition of McKinnon (1973) and Shaw (1973) was clouded. Almost all developing countries experienced widespread banking sector problems, recessions and increases in poverty and income inequality (for references, see Arestis and Caner, 2005).

How does FL lead to fragility and financial crises? In a simple two-period model of borrowing and investing, capital markets could go wrong when uncertainty about payoffs to new investments increases after financial reform. With moral hazard, capital mobility and deposit insurance, banks lend exuberantly, which sends over-optimistic signals to firms about the outcome of the reforms. Firms over-borrow and over-invest. Savings decline and the current account deficit grows rapidly. If the outcome of the reform turns out to be less favourable than expected, firms have trouble repaying investment loans and this puts the banking system in serious trouble. Another possibility is that FL intensifies financial instability by acting as the key euphoria-inducing factor and threatens growth and employment. Under FL, economies are forced to bear a greater degree of risk than otherwise, so that the euphoria spread by FL produces financial crises (for details and references, see Arestis and Caner, 2005). It is also possible that FL changes the structure of financial sector. For example, the change could be away from supporting real capital formation and towards speculative or even Ponzi ways of finance. This inevitably would result in more

frequent crises, and in a lower share of labour income, and in net resource outflows from developing countries, all of which are symptoms mentioned elsewhere in this contribution (see, also, Arestis and Glickman, 2002).

According to Tornell et al. (2003), crises are ‘the price that must be paid to attain rapid growth in the presence of contract enforceability problems’ (4). Unless judicial reform is implemented to improve domestic credit markets, FL will lead to financial fragility, as risky bank flows that are necessary to avoid bottlenecks become the only source of finance for a large group of firms. Important for our regional analysis, the link between growth and crises exists only for countries where contract enforceability is not strong. This implies that the crisis-inducing effect of FL varies across countries according to the degree of contract enforceability in those countries. There is also the possibility that the lack of careful management and sequencing of FL lead to financial fragility and crises. However, sequencing does not appear to be justified in empirical work (Prasad et al., 2003). Opening the capital account or the stock market does not have a different effect than opening the domestic financial sector. But one exception exists; crashes seem to be larger in emerging markets if the capital account opens up first (Kaminsky and Schmukler, 2003, 31).

Empirical work on the impact of FL on macro-economic volatility and crises provides evidence of an increased likelihood for countries that have gone through FL of eventually being hit by financial crises. Kaminsky and Schmukler (2003) observe that, although equity markets stabilize in the long run (i.e. in 5 years or longer) if FL persists, the amplitudes of booms and crashes substantially increase immediately following FL. How do financial crises affect poverty? First, crises typically lead to a fall in earnings of both formal- and informal-sector workers with varying impacts on workers with different skills and different levels of job security. Secondly, the distribution of income is affected by changes in relative prices of tradables relative to non-tradables, interest rates as well as changes in asset and property prices. Thirdly, contractionary fiscal policy that is traditionally implemented in response to a crisis

leads to cuts in social programs. Other reasons why crises may affect the poor differently include the asymmetric effects of increased rate of inflation on the poor and the ‘labour hoarding’ hypothesis (for details, see Arestis and Caner, 2005).

Most of the empirical evidence on the effects of crises on poverty supports the argument that crises have an aggravating effect on poverty. We may refer to the South East Asian crisis to make the point and to figures reported in Agénor (2001). Over the period 1997–1999, the incidence of poverty (as measured by the national poverty line) increased from 11 to 18% in Indonesia, from 11.4 to 12.9% in Thailand and the urban poverty headcount rose from 8.5 to 18% in South Korea. The income of the poor fell as a result of both lower real wages and higher unemployment: in Thailand real wages fell by 4.5% (and unemployment increased from 2.2% in 1997 to 5.3% in 1998), in South Korea real wages fell by 10.6% (and unemployment increased from 2.6% in 1997 to 8.4% in early 1999) and in Indonesia real wages fell by 44% (and unemployment increased less dramatically than in the other two cases, but ‘disguised’ unemployment rose).

It is clear that the crisis channel of interaction must be incorporated in any analysis of FL on poverty or inequality. Overall, the current evidence suggests that FL can increase a country’s vulnerability to financial crises, which are likely to hurt the poor disproportionately. Moreover, financial crises not only affect the current position of the poor but also lead to a reduction in the limited human capital of the poor, thereby affecting their ability to grow out of poverty. The challenge for policy makers, then, is primarily to take measures to avoid crisis situations if FL is to be pursued. The roles of exchange rate policy, capital controls and counter-cyclical fiscal policy in generating or avoiding crises should be taken into consideration (see Lustig, 2000, 6–11). Lustig (op. cit.) summarizes the relevant policies that include improved prudential regulation and supervision of financial intermediaries; new standards of data dissemination and implementation of corporate bankruptcy reforms. It is equally important to choose pro-poor responses to crises in case they cannot be avoided.

The incomes of the poor should be protected in the face of macroeconomic adjustment by using appropriate policy options, such as maintaining safety nets and carefully selecting the composition of fiscal adjustment. For it is the case that ‘(s)ocially responsible macroeconomic policy in crisis avoidance and crisis response can contribute simultaneously to lower chronic poverty and higher growth’ (Lustig, 2000, 18).

Of great interest and relevance to this section is of course the world financial crisis that began in August 2007 and that is still exercising the policy maker and troubling especially the poor. The impact of the current crisis on poverty is a serious matter and worth commenting on, although the subject-matter of this contribution is not strictly related to a crisis that is still taking place. The difficulty with this financial crisis is that unlike the relatively minor and transient kind of crises discussed in this section, the August 2007 crisis is a major global recession (even a possible depression). This financial crisis is being accompanied by direct policy measures to allocate credit to ‘small firms and the (housing) poor’ in many Organisation for Co-operation and Development and in the emerging economies and less developed countries. This, however, is being done in the context not of FL but financial re-regulation in various ways. What is of particular interest in this context, however, is that this crisis has come about as a result of the FL, which had been going on since the 1970s, along with financial innovations that emanated from that era, and the easy monetary policy over the period since the equity crisis of March 2000. These three factors have played a significant role in creating and promoting the August 2007 financial crisis (for full details, see Arestis and Karakitsos, 2009).

The Access to Credit and Financial Services Channel

The FL process and financial development that usually accompanies it can have profound effects on the availability of credit and financial services for the poor.⁷ The proponents of FL argue that it leads to financial deepening and better access to credit for

previously marginalized borrowers and savers. For a given level of deposits, the reduction of reserve requirements increases the supply of credit. A rise in the interest rate increases savings and bank deposits thereby allowing banks to supply more loans. Moreover, the removal of barriers to entry increases competition and motivates banks to extend their services to traditionally excluded sections of the population.

Nonetheless, it is the case that financial sector reforms do not increase the supply of loans to small firms and the poor. From the banks' point of view, it is more expensive to lend to the poor due to higher processing, administrative and monitoring costs and higher risk of default. Since banks emphasize profitability rather than other lending criteria such as the viability of the project or social outreach, banks may naturally prefer doing business with established companies rather than the poor even after financial sector reforms. Various studies report that, in developing countries, it was the established borrowers and not the small firms or the poor who had access to more credit or better terms of borrowing after FL. Furthermore, rising interest rates affected the credit demand and credit repayment of the poor negatively (for references, see Arestis and Caner, 2005).

The impact of FL on the poor could also work through its effect on the interaction between formal and informal financial markets. In developing countries, the informal financial sector has usually a more important role. It has been shown that roughly 40–80% of economic agents in developing countries lack access to the formal banking sector (Beck et al., 2007a; World Bank, 2007). If FL expands the formal sector at the detriment of the informal sector, it can hurt the poor substantially given that the poor operate mainly in the informal sector. Lensink (1996) finds that this actually happened in a number of sub-Saharan African countries. What the proponents of these FL programs fail to recognize is that the formal banking sector in these countries is relatively unimportant for the financing of investment projects.

In contrast, a flourishing informal financial sector exists. The informal lender, due to having better knowledge of the borrower, has better opportunities to discriminate among borrowers with high and

low risks and to charge appropriate interest rates. Liberalization programs that ignore these aspects can reduce the overall efficiency of capital allocation process by shifting funds from the better informed informal to the poorly informed formal sector (Lensink, 1996). Ayyagari et al. (2008) examine firm financing patterns in China and find that a relatively small percentage of firms in the sample rely on formal bank finance; the informal financial sector plays a significant role. Firms that rely on the formal sector, though, grow faster, have higher productivity and profit reinvestment rates. However, when informal financing is defined to include internal financing, the informal finance sector has higher productivity growth and profit reinvestment rate, but not higher growth than the small formal sector. But, then, four large state-controlled companies dominate the Chinese financial system; state-owned banks enjoy a large share of bank lending. Ayyagari et al. (2008) produce evidence suggesting 'that the firms which receive government help in obtaining bank financing do not grow as fast as firms which report no government help' (37).

The role of microfinance institutions in terms of this channel cannot be emphasized enough.⁸ These institutions have the advantage of proximity to the market they serve and, therefore, enjoy better knowledge of the community. They provide services to those who are not served by the formal sector and therefore complement the formal financial system. Lanzi (2008) discusses microfinance from the point of view of it being 'a characteristically social enterprise' (203). The conclusion reached is that microfinance institutions 'are no more than financial service providers specialized in offering services Thus, microcredit is far from being the capitalism-compatible tool of liberation (in the Marxist sense) of the poor and this piece of news cannot shock economists since, following Marxism, no capitalism-compatible ways towards the freedom of the poor actually exist' (209). A slightly alternative view is propounded by Cull et al. (2008) who analyze data from 346 of the world's more important microfinance institutions dealing with 18 million borrowers and show that microfinance institutions can in fact provide reliable banking services in a commercially

viable way to poor customers. They argue that although profit-maximizing investors would have limited interest in the institutions that attract the poorest customers, the microfinance sector has grown substantially with its emphasis on social objectives.

Microfinance institutions have been able to expand services, improve quality and successfully innovate to tackle problems of asymmetric information, yet challenges to high costs remain. Such success has not yet proved to increase economic growth or to reduce poverty on a large scale. Consequently, microfinance institutions should pursue a more profit-seeking objective (Prahalad, 2004). Cull et al. (2008) respond to this suggestion by arguing that the empirical assertions used to support this argument are questionable. The challenge in their view is to take advantage of the new opportunities of the market place as offered by microfinance and to recognize at the same time that potential trade-offs always exist. World Bank (2007) suggests that microfinance is not overwhelmingly beneficial and displays a great deal of skepticism in this study as to whether microfinance can produce a significant reduction to poverty. We might add to this the fact that rates of interest charged by micro-finance institutions can be astronomically high for the informal sector. This consideration may very well defeat the aim of the microfinance exercise in certain cases of really weak informal sectors.

To summarize the argument of this section, it is rather unclear whether the consequences of FL for access to the financial market by small customers and the poor are adverse or beneficial. Clearly, the effect of FL on the availability of credit and financial services to the poor depends on the initial financial structure of the country in question, in particular the balance between formal and informal sectors and the market structures of these two sectors. On the one hand, increased competition and improved distributional efficiency will lead financial institutions to seek markets normally rationed out. In this case, small borrowers with good business prospects but insufficient collateral will benefit. On the other hand, financial sector reforms may leave the basic structure of the banking system unchanged, thereby protecting or reinforcing the oligopolistic position of banks. In this

case, previously marginalized customers will not have greater access and some may even be excluded. In many countries, financial sector reforms so far have not embraced the broad agenda of developing the institutional structure and new instruments to satisfy the financial needs of small enterprises and the poor. FL is not sufficient to improve access to credit and financial services by the poor, given the empirical evidence from developing countries. Moreover, even if credit and financial services are extended to small customers and the poor, it is doubtful that improved access by itself will eradicate poverty.

The Income Share of Labour Channel

FL might affect poverty by changing the share of labour in national income. We know that with increasing global competition and capital mobility, rents in production are considerably squeezed. However, the share of capital in these reduced rents is increased, since capital can search for higher returns abroad more easily in a liberalized regime than before, thus enhancing its position in a strategic bargain with labour. That financial capital is more mobile while labour (especially unskilled) is far less mobile across national boundaries than they used to be is one feature of today's international labour and capital markets. According to Rodrik (1997), increasing capital mobility could give more bargaining power to capital over labour. As world-wide trade and investment opportunities for employers are increasing, they are able to move across borders more freely. This leads to an increase in the demand elasticities for immobile factors such as land and unskilled labour. Heavy reliance on external markets provokes cut-throat competition especially in labour-intensive activities. Wages race to the bottom to attract capital. Another implication is that during a crisis, capital can threaten to flee unless it receives the world interest rate plus a risk premium, whereas labour cannot flee and has to bear the burden. On the other hand, increased reliance on domestic markets would require a rise in the purchasing power of the poor to enlarge the domestic market. Finding the right balance between an emphasis on external versus domestic markets requires careful planning.

So far, there are only a few studies on the link between FL and labour's income share. One example is the study by Jayadev (2007), where the effect of FL on the labour share of output is estimated. In this attempt, an index of capital account restrictions is used, based on data from 140 countries over the period 1972–1996, and controlling for macroeconomic trends and changes in endowments. Panel data estimates reveal that capital account openness exerts a robust and significant negative effect on the labour share of income. The effect is robust across many subsets of developing and developed countries, except for the low-income country sample. Furthermore, the losses of labour are not temporary, but they persist through the medium term (5 years).

Harrison (2002) models the bargaining process between firms and workers on the division of excess profits between capital and labour in an imperfectly competitive theoretical framework where firms make excess profit. In her model, bargaining strength is a function of the fixed costs of relocating and the alternative return available elsewhere. To the extent that the fixed costs of relocating are larger for labour than for capital, the bargaining process could lead capital's share of national income to rise relative to labour. Applying the model to data for more than 100 countries over 40 years, Harrison (*op. cit.*) finds that rising trade openness and exchange rate crises reduce the output share of labour, while capital controls and government spending increases it.

It has been suggested that the effect of financial globalization on the inequality between the income shares of capital and labour does not operate monotonically and smoothly through time. It rather operates via short-term severe disputes during crises. Through changes in the distribution of income between labour and capital, labour partially bails out capital in resolving crises, and therefore it is not hurt unintentionally. As empirical support for this thesis, Diwan (2001) reveals an inclination for labour share to fall sharply during a financial crisis, recovering only partially in subsequent years. The author also finds that the decline during a crisis can be partly explained by the degree of leverage in the country, the nature of its financial structure and the openness of its current and capital accounts.

An important 'intermediate' consideration in this regard is educational/skill upgrading. On the one hand, FL could help labour enhance its skills; this is actually one of the main ways, beyond the bargaining power of labour, that income share of the poor could be increased. On the other hand, FL can change production and management practices in such a way to diminish the role of labour vis-a-vis capital. Therefore, the initial level of human capital in a country, as well as the skill requirements of the activities created or enhanced by FL are important determinants of how FL will affect poverty via changing the income share of labour. Definitely, more research is needed on examining these points as they are missing in the literature.

We may summarize the rather small amount of evidence produced so far on this channel. It provides support to the thesis that FL can actually reduce the share of labour in income. Since labour income is the major income source for the poor, this channel of interaction shows that detrimental effects on this group of people that emanate from FL are evident. However, as mentioned before, a great more research is needed on this channel.

Summary and Conclusions

We contribute to the debate on FL and poverty by criticizing the current approach in the literature and by identifying three further channels of interaction between FL and poverty: the crises channel, the access to credit and financial services channel and the income share of labour channel in addition to the growth channel that is usually mentioned, or implied, in the literature. Our work reveals that FL has a complex relationship with poverty. The trickle-down effect of economic growth accompanied by FL is what is usually assumed to benefit the poor, yet theory and evidence tell us that this is not always the case. When a uniform FL program is applied to all developing countries regardless of their specific needs and without first maintaining macroeconomic stability and without establishing the supporting institutions and policies, even when it brings economic expansion, it often comes at the cost of devastating crises and increasing economic

inequality. The poor appear to pay a higher price than the rich in the aftermath of these crises.

Although financial repression may not be desirable in that it has its own problems, it is clear by now that its alternative has not been free of problems. On the contrary and as we have shown, it has been marred with all sort of problems, especially so when it comes to the poverty question. If FL has to be introduced, it must be designed with poverty reduction as its thrust in order to benefit the poor. Otherwise, the market by its nature will benefit those who already have access to economic resources or to information and those who are strategically positioned to take advantage of the opportunities offered by the market, as already experienced by many developing countries.

The reduction of extreme poverty by half by year 2015 as stated in the Millennium Development Goals (United Nations, 2000) is a big challenge for policy-makers worldwide. In fact, it is too optimistic to expect these targets to be reached. What is noteworthy is that international institutions that are the most influential in determining development strategies are still highly influenced by the liberalization idea. It appears that although these institutions cannot deny the importance of the poverty problem, they remain firmly attached to their policies, which forbids them from taking influential steps towards eliminating poverty. As a result, the operations of these institutions have only a soothing effect rather than really curing the problem. What is actually needed to solve the poverty problem is a different vision, one that emphasizes employment creation, redistribution and encouraging specialization in critical industries that create high value added. This vision would also need a re-thinking of the role of the state in development. Recent evidence supports that countries that designed their own strategies have become more successful than those who merely adopted the policies of international institutions. A new vision on poverty elimination would therefore bring the importance of basing development strategy on the specific conditions of a country to the forefront.

A final comment relates to the question of why we have concentrated merely upon the relationship between FL and poverty and have not accounted for

inequality as well. We believe that proper treatment of inequality would require a great deal more, which would go beyond the purpose of this contribution. It is of course the case that poverty has attracted the attention of the World Bank and other organizations and institutions dealing with development and growth. While it is true that this work avoids any serious discussion of inequality, it is still obvious that in these studies the purpose is to concentrate on the issue of poverty. The question of inequality and growth has been studied separately from poverty as for example in Barro (2000), where one finds that the Kuznets curve is 're-invented' as an analytical device for representing the relationship between inequality and growth over the 'poverty to richness' cycle. Even in that study, the discussion of poverty is not directly focused. In other words, a separate in-depth study is required to account properly for the relevant dimensions of the impact of FL upon inequality.

Endnotes

¹ The estimates referred to in the text use the \$1 a day poverty line for Indonesia and the Philippines and \$2 a day for Malaysia and Thailand.

² This paper relies to some extent on Arestis and Caner (2005) to which we make extensive reference in this contribution. However, it extends the analysis in a number of ways, three being particularly worth mentioning. First, this contribution looks at the relevant experiences of developing countries. Second, it develops further the argument about the three channels of how FL might affect poverty. These are the economic growth, the financial crises and the access to credit and financial services channels. Finally, a fourth channel is put forward for the first time, this being the income share of labour channel.

³ The case of Mexico in the 1980s is also relevant to our analysis. Tornell et al. (2003) argue that Mexico actually 'shifted from a highly interventionist to a liberalized economic regime' with extensive FL, but as the evidence produced therein shows 'In terms of GDP per capita, Mexico's performance has in fact been reasonable but unremarkable' (26). FL in Mexico over the period 1989–1999, actually led to financial fragility, serious financial crises and credit crunch. Poverty severely worsened as a result.

⁴ Authors' addition.

⁵ A formal financial system is defined to include banks, securities markets and the full range of other similar-like institutions. Micro-credit programmes and informal systems are not included. Informal financial institutions are non-market institutions such as credit cooperatives, money lenders etc.; unlike the former, the latter institutions 'do not rely on formal contractual obligations enforced through a codified legal system' (Ayyagari et al., 2008, 2).

⁶ Demirgüç-Kunt and Levine (2008) isolate the 'measurement of financial development' as an area that needs a great deal more work. A relevant example is 'private credit', which is used widely in relevant research for it is available in many countries over a good number of years. Although it captures the depth of the financial system, as a variable in the area under discussion, it tells us very little of 'how widely access is available' (15).

⁷ Beck et al. (2006) examine the possibility of the existence of barriers to banking services. Using surveys of 193 banks in 58 countries they conclude that cross-bank and cross-country variation in barriers to banking exist. Furthermore, Beck et al. (2007a) employ aggregate cross-country banking data, five large banks in 80 countries, and reach similar conclusions.

⁸ There are other market-based strategies for poverty alleviation besides microfinance that have proliferated in recent years. These are individual development accounts (based on the hypothesis that the poor will save if provided with the same incentives and mechanisms as the non-poor) and bottom-of-the-pyramid strategies developing products and services (especially designed for the poor by private firms). Although such strategies will probably be beneficial only in some cases and to only some people, they are certainly new alternatives to poverty alleviation that should be kept in mind when designing financial sector reforms.

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