Exploring the Link between Capital Account Liberalization and Poverty

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12 February 2001

Much has been said about the effects of capital account liberalization, especially in relation to bringing about economy-wide, nay, global crises. A wearisome debate in the aftermath of the 1997 financial crisis tackled whether the crisis was an offshoot of the contagion (hence externally induced) or incorrect internal policies resulting in bad economic fundamentals. This was a debate that tried to establish whether the internal or the external factor was principal. Arguably, both factors contributed to the crisis.

At any rate, the relevance of stricter regulation of the capital account (including the use of capital controls) applies to either case. 8

Take the case of a country with weak fundamentals like the Philippines. The financial crisis in the Philippines was mainly brought about by the related problems of high domestic interest rates and an overvalued currency. This in turn led to a widening current account deficit, a shift of investments from the tradable to the non-tradable sectors, hence a slowdown of the real sector of the economy, and eventually a recession. But this problem is inextricably tied up to capital inflows from abroad, attracted by the higher return on domestic assets (e.g., higher interest rates and stock market boom). On the other hand, the massive capital inflow (still much less than the flows received by neighboring fast-growing economies) misaligned the exchange rate, with the peso being significantly overvalued by at least 50 percent vis-à-vis regional currencies. All this would suggest that measures to discourage portfolio capital from abroad should have been an integral part of economic policy.

For the other Southeast Asian countries hit by the crisis, the liberalization of the capital account and of the financial markets was the main combustion, with the contagion fueling the fire.

In the wake of the Asian crisis, it has become unmistakably clear that capital account liberalization poses economy-wide risks. And at the very least, there is consensus that sequencing, strong prudential regulations, and supporting institutions become necessary conditions to make capital account liberalization work. Even the free-market adherents concede that capital control could be applied in extraordinary circumstances or that a tax could be imposed on short-term flows. (The Chilean example is widely mentioned.)

Scope of Studies

The severe repercussions of the series of financial crises since the 1997 Asian financial crisis (not to mention the earlier shock in Mexico) have sparked intense debate on capital flows in emerging market economies.

Numerous studies pertain to the internal and external factors that led to the different crisis episodes. In a similar vein, the literature is rich with insights into the debate on whether the recent crises were mainly caused by domestic or international factors. Many scholars have likewise described and analyzed the policy responses before, during, and after a crisis.

Not surprisingly, scholars and advocates have identified and dissected the broad range of options for capital regulation and controls--from prudential regulation, market-based regulation such as the Chilean example of a tax on short-term flows, control on outflow a la Malaysia, to a Tobin-type currency transaction tax. Studies on institutional reforms at the global level (for instance, restructuring the international financial architecture, and tighter regional and international coordination) have also gained currency.

From a developmental perspective, numerous studies on the impact of the financial crisis on poverty and inequality have been undertaken. The multilateral institutions--for example, the World Bank and the Asian Development Bank--have published papers and organized workshops and conferences around this subject.

Yet, what remains unexplored is the impact of capital account liberalization on poverty and inequality. More to the point, the social costs of capital account liberalization even *before* the crisis strikes (i.e., during normal times) has so far received scant attention in terms of conceptual and empirical work. The task of demonstrating the relationship between capital account liberalization on the one hand and poverty reduction and inequality on the other hand is indeed daunting. But the challenge has to be met.

Undoubtedly, addressing poverty and inequality problems is a chief concern of developmental organizations, especially progressive non-governmental organizations (NGOs). It is therefore worth our while to test whether we can establish a connection between capital account liberalization and poverty/inequality.

Exploration of the Problem

At the outset, let it be said that it is difficult to establish a direct link between capital account liberalization and poverty. To put it another way, the link can be established indirectly through macroeconomic mechanisms such as fiscal policy, monetary policy, and exchange-rate policy. Attributing adverse effects to capital account liberalization becomes all the more complex since the determination of macroeconomic policies rests on other considerations and objectives.

Moreover, regardless of the policy on capital account liberalization, poverty reduction will be first and foremost determined by whether government's economic program and policies are in the first place pro-poor. It may be argued then that the effects of capital account liberalization on poverty are at best contributive.

This is not to dismiss the relevance of the link; rather it demonstrates how extraordinary the challenge is to advance the proposition that capital account liberalization contributes to poverty.

Studies on the impact of capital account liberalization on poverty are undeveloped. It was for this reason that Oxfam Great Britain and the Bretton Woods Project has embarked on a research that discusses the said issue. The output of the project has been a draft titled "Capital Account Liberalization and Impacts on the Poor (January 2001), written by Alex Cobham. Oxfam Great Britain and Bretton Wood Project also convened an expert group meeting to critique the draft.

Also forthcoming is the work of Valpy FitzGerald[1] of Oxford University's Queen Elizabeth House titled "Short-Term Capital Flows, the Real Economy and Income Distribution in Developing Countries." In this discussion, we use the Cobham paper as the basic reference.

The Cobham paper on capital account liberalization and its impact on poverty is indeed refreshing, for it substantially discusses and analyses the costs of capital account liberalization during the so-called normal imes. The studies on the said subject in the past few years (i.e., in the aftermath of the 1997 financial crisis) understandably focused on the impact resulting from the crisis. Until this time, the literature on the social effects of capital account liberalization during the non-crisis or pre-crisis period has been scarce. But as Cobham argues many significant costs "are associated not with crisis periods, but rather periods of capital *inflow*."

Taking off from the Cobham study, this paper focuses on the macroeconomic channels in which capital account liberalization could affect poverty. To wit: fiscal, monetary and exchange-rate policies.

Government Finances

Fiscal policy as a channel of transmission covers the following areas: worsening terms of public borrowing, tax competition, the foregone spending arising from the interest costs of sterilization, and the tight rein on government spending arising from the pressure of market discipline.

One cost elaborated on the Cobham paper pertains to the constraint on government finances. The proneness of many developing countries to borrow to finance growth makes it tempting for them to liberalize their capital accounts. The Cobham paper describes debt "as the sole most effective tool for governments to smooth their expenditures and protect the poorest," the reason being that other sources of government financing are "typically unstable."

To be sure, governments should rely mainly on national savings, including taxes, before resorting to borrowing. But the problem of some countries, including the Philippines, is that even in times of growth, tax collection is below performance. That is, even when there is economic recovery or growth, tax collection as a proportion of GNP remains dismal.

[1] FizGerald was a moderator and resource person in the expert group meeting on Capital Account Liberalisation and Impacts on the Poor, convened by Oxfam Great Britain and Bretton Woods Project, hosted by Queen Elizabeth House, University of Oxford, and sponsored by the UK Department for International Development, 11-12 January 2001.

This defies the conventional theory that tax collection is buoyant in times of growth. Growth is not only the determinant of tax receipts. Other important variables include the efficiency of tax administration, the extent and degree of tax evasion, the confidence in governance, and the quality of growth itself.

The point is, putting in place a comprehensive tax reform agenda that makes the tax system efficient, progressive and buoyant reduces the temptations of governments to liberalize their capital accounts.

In the case of high-growth economies wherein national savings together with tax collection are relatively high (e.g., Korea), capital account liberalization became an attractive substitute to painful domestic reforms as a means to obtain more capital that is needed to reach a higher level of economic maturation. Arguably, the broadening of the scope of reforms (to cover fiscal monetary, exchange rate, trade and incomes policies) will shrink the role of capital account liberalization to obtain access to financing. Admittedly, some of these reforms are non-populist and painful. Bluntly said, capital account liberalization has become a lazy way of getting financing.

Tax Burden

Still on the issue of taxation, the Cobham paper says that capital account liberalization, specifically the attendant risk of swift outflow, "will lead to the tax burden falling more heavily on the less mobile factor--labor."

This needs elaboration as we surface certain nuances. The obvious goal of capital account liberalization is for a capital-deficit country to attract capital. But capital account liberalization by itself does not automatically translate into significant capital inflow. For one thing, a capital-scarce country would still have to compete with other countries that want a bigger share of capital coming from abroad. This brings to fore the issue of locational competition. In the words of Hort Siebert (1996), "countries compete in the world market for capital, technical knowledge, high-skilled mobile labor and, to some extent (for instance in historical cases) residents."

Tax policy--the use of incentives--is an important tool to engage in locational competition. The incentive to tax capital less stems from both desires to attract capital inflow and the desire to stem the outflow.

The implication of this is that it is not labor in general that suffers from the heavier tax burden but that part of labor that is the least mobile (the poor, in short). In the first place, we distinguish between highly skilled, highly educated labor (which is hence a highly mobile factor) and the lowly skilled, lowly educated labor. Highly mobile labor would tend to benefit from the reduction of income tax rates.

Because of tax competition, the governments in capital-scarce countries are tempted, if not compelled, to reduce income tax rates. This, however, would make the tax structure less progressive or more regressive. With the share of revenues sourced from direct taxes (corporate and individual) shrinking (and may we add the reduction of tariffs as well), governments will rely more and more on indirect taxes and user fees. Undoubtedly, this will impact not only on labor in the formal sector but also labor in the informal sector and the unemployed.

Sterilization

Another aspect of fiscal policy as a transmission mechanism pertains to the costs of sterilization. The management of capital inflows by way of sterilization in which domestic interest rates are higher than interest rates for the rest of the world results in opportunity costs. The difference between the cost of higher domestic interest rates and foreign interest rates are foregone expenditure. In short, the opportunity costs of sterilization result in the reduction of the level of government spending for, say, development programs.

The other cost of sterilization, especially in times of growth, is the crowding-out effect of public borrowing, which limits private investments and in the process hurts employment.

Higher interest rates arising from sterilization also have a social cost (e.g., employment), but this is more appropriate to discuss in relation to monetary policy.

It must be nevertheless clarified that in the absence of a restricted capital account, government has to undertake sterilization of capital flows to protect the real sector (e.g., from an overvalued currency). The problem arises when the increase in public debt to be used for sterilization exerts upward pressure on interest rates, which would attract more hot money from abroad. In this sense, sterilization is unsustainable and hence to be used only for a short period.

Market Discipline

Capital account liberalization also entails market discipline, especially on fiscal policy. FitzGerald points out that the investors' perception on the debt sustainability or fiscal solvency differs from that which government considers as the desirable level. Investors prefer a low deficit or a fiscal surplus whilst government wants more borrowing flexibility to finance public investments. And in the situation that the debt-to-GDP ratio increases significantly in times of bullish expectations and a surge of short-term capital flows, government finds it compelling to reduce borrowing and lower the fiscal deficit. In short, government accommodates the investors' perception and expectation, hence constraining public sector borrowing and fiscal policy in general. Most affected by this, FitzGerald argues, is public investment spending. This, in turn, has a negative effect on infrastructure necessary for long-term growth and essential social services for human development.

The market discipline argument, it is contended, may help reduce inefficiency in public spending. In this regard, the Cobham paper argues that "where governments are using fiscal deficits inefficiently, the market discipline effect of liberalization will be to curtail the wasteful use of limited resources." In effect the paper, points out that this may have "no direct poverty effects." The proposition that market discipline is an effective way to curtail inefficient fiscal deficits is based on the assumption that the target of having a low budget deficit or a balanced budget would compel government to spend wisely and efficiently.

On the other hand, one can argue that the reduction of government spending, even if such spending was inefficient, would still have an impact on poverty reduction. The cut in deficit spending would still reduce the expenditures for social and economic services.

I recall the action of a clean and honest Cabinet official--the secretary of the graft-ridden Department of Public Works and Highway in a previous administration--to reduce spending for infrastructure projects in a bid to minimize graft and corruption in the department. Infrastructure activities almost came to a standstill. To some extent, he succeeded in neutralizing graft and corruption but at the cost of severely undermining public infrastructure, which resulted in supply bottlenecks, a rise in inflation, and an eventual growth slowdown.

We have to be emphatic in criticizing the current tendency to dogmatize the correctness of low budget deficits based on a rigid benchmark. The dogma absolutely treats low budget deficits or balanced budgets as part of market discipline and good fundamentals. But where on earth is the evidence that a budget deficit breaching three percent of GNP or approximating four percent of GNP is "alarming" (the word used by pundits to describe the Philippine government budget deficit of four percent of GNP)? Historical contexts and national specificities are ignored. Take Korea; it had the courage to defy market discipline when it incurred a government budget deficit that was more than double the so-called alarm level.

In the Philippine case, I will be the first to concede that the deficit of the Estrada administration before his downfall was indeed alarming. But my point has nothing to do with what is an acceptable deficit level. The Estrada administration incurred the deficit to cover up its failure to collect taxes and combat tax evasion. The Estrada administration simply did not have the political will to reform tax administration and go after big-time tax evaders. After all, as the evidence in his impeachment trial revealed, Mr. Estrada himself and his cronies were the biggest tax evaders at that time. Further, the Estrada administration used massive government resources to undertake populist but economically unsound measures and prop up a morally bankrupt and venal administration.

But the Estrada episode had an extraordinarily different context. In the past, the Philippines suffered from either self-imposed or IMF-imposed stringent budget deficit targets, even in times when anti-cyclical fiscal stimulus was necessary.

Illusory Gains

A final parting shot on so-called market discipline (market sentiment is perhaps the more appropriate word) is that some economic indicators that supposedly reflect good fundamentals are in truth illusory. The Cobham paper points out the uncertainty arising from macroeconomic instability, which in turn is brought about by the volatility of short-term capital flows. But in the short run, seemingly good economic indicators mask the uncertainty. For example, what investors or fund managers see are lower inflation, a stable exchange rate, and a boom in the stock market and real estate.

To go back to the Philippine experience, lower inflation was partly a result of high domestic interest rates and an overvalued currency. The stable exchange rate was the result of the pegging of a misaligned exchange rate. And the boom in the stock market was but an asset bubble arising from over-investment, especially in the nontradeable sectors like real property, financial services, and utilities.

And so, the above indicators signaled stability and predictability. Investors proceeded to make what seemed to be rational decisions. For instance, with capital account liberalization and a predictable (nay, fixed) exchange rate in place coupled with higher domestic interest rates, the investors (including those unhedged) sourced their borrowing from abroad. Alas, in an instant, the crisis struck and punished them for their "rational" behavior.

Exchange Rate and Interest Rates

The pernicious effects of high interest rates and an overvalued currency need further elaboration. Higher interest rates as a result of sterilization lead to a dampening of investments and a rise in unemployment. Further, higher domestic interest rates attract more capital from abroad, leading to further currency overvaluation.

In turn, the strong or overvalued currency undermines the real sector of the economy. Both exports and import substitutes are penalized. The overvalued currency makes exports expensive and imports cheap to the detriment of competing domestic goods. Again, this means displacement of workers both in agriculture and in industry.

Moreover, the overvalued currency leads to investors shifting from tradable to nontradeables. For a country with a soft state (the Philippines being a good example), this would all the more reinforce the "booty capitalist" character of the state. Paul Hutchcroft (1998) defines booty capitalism as a patrimonial state typified by business interests capturing the state apparatus. To be sure, the capture of the state's regulatory power becomes a main agenda of vested interests engaged primarily in nontradeables such as utilities, telecommunications, transportation, and real property.

Rethinking Growth Strategy

Finally, the debate on capital account liberalization is linked to the debate on growth strategy. Undeniably, growth is a necessary condition to eradicate poverty. But the debate revolves around the quality of growth. Capital account liberalization, it is argued, is necessary for growth.

Empirical evidence (and common sense) would show that financial flows merely follow growth. This is the direction of the causality. Among the variables that attract capital from abroad are a) the rate of return on domestic assets being greater than the rate of return on assets of the rest of the world (in this regard, interest rates are a proxy to assets) and b) the risk premium.[2] It is hence unsurprising that the major recipients of

[2] This is algebraically expressed in the following: $r-R = z+ (E^*-E)/E$, in which:
r stands for the return on domestic assets,
R stands for the rate of return on domestic assets,

capital or financial flows are the high-growth economies, especially in East and Southeast Asia.

Clearly then, it is in normal times or in times of growth that all kinds of capital are pouring into the economy. And it is precisely during these times that an extraordinary measure like capital control is necessary.

The liberal flow of capital may inflate growth, but such growth as the 1997 crisis has proven, is risky and unsustainable and has enormous social costs. Policymakers have surely contemplated the bitter lessons of the 1997 global financial crisis. Hereupon, will policymakers allow capital exuberance to dominate the economy in the name of growth? Or will they temper the growth by, inter alia, screening capital flows as a means to make growth more sensitive to development goals?

It is with a sense of relief to know that even the most conservative institutions like the IMF have conceded the relevance and appropriateness of capital controls under certain conditions. Such acknowledgment, hopefully, will move forward the debate towards formulating the policies and measures that will check the dangers attendant to excessive and fickle financial flows.

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E stand for the current exchange rate in the spot market,
E* stands for the expected exchange rate in the future,
Z stands for the country's risk premium.

This is to say that the difference between the rates of return on domestic assets and foreign assets is equal to the risk premium and the expected rate of depreciation (E*-E)/E. Domestic interest rates and international interest rates can serve as proxy for r and R, respectively.

By rewriting the formula, we get: $E=E^*/(r-R - z + 1)$. This states that the current exchange rate is determined by the expected depreciation (or appreciation) of the exchange rate, the difference of the rates of return on domestic and foreign assets and the risk premium. Specifically, an increase in E* will likewise increase E (depreciation). On the other hand, a bigger return on domestic assets than on foreign assets and a lowering of the risk premium will lower E (appreciation). See, for instance, de Dios (1995) and FitzGerald (forthcoming).

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