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Capital Liberalisation and Economic Instability

By Kalim SIDDIQUI †

Abstract. This study intends to examine the larger issues related to capital liberalisation and also to analyse the reasons for recent support of capital mobility and its repercussions for the future prospects of the economies of developing countries. The objective is to critically examine relevant empirical and theoretical studies in order to answer these questions and address the objectives of this study. The methodology adopted in this study relies on secondary information, reports and published studies to address the research questions. The study finds that following the adoption of capital liberalisation and neoliberalism, the economies of most developing countries have become more vulnerable. If China is excluded, we find that most developing economies have been unable to expand employment opportunities or reduce levels of poverty. In recent years capital liberalisation policy has encouraged capital flight from their economies.
Keywords. Capital Liberalisation, Financialization, Instability and developing countries.
JEL. E44, E52, F21.

1. Introduction

This study aims to provide a deeper understanding of developing economies, by not simply re-emphasising the importance of capital control, but also highlighting the dynamics of transition that these economies are facing. The word 'capital' can be used to refer to "foreign direct investment", that is capital invested into productive assets, which is not liquid, and "portfolio investment and bank loans", which are highly liquid and could have wider impact on a country's economy if left to flow unrestricted across borders. Financial liberalisation is a set of measures including central bank autonomy and freedom of movement of capital, and can also mean convertibility of currency, abandoning 'priority sectors', and adopting a policy of lending at differential interest rates to promote strategic sectors or industries in the domestic economy (Chang & Grabel, 2014).

Economists refer to capital control as a range of policies that are designed to manage global capital flows. Such policy initiatives can take many forms. For instance, restrictions can be placed on foreign investment in certain sectors, on capital outflows, or on access to the domestic or foreign currencies. Capital control received more support following the East Asian crisis in 1997-98 since previous policies of capital liberalisation as a result of IMF pressures resulted in a huge inflow of foreign capital into the East Asian economies, which was reflected in a lending boom and domestic banks taking greater risks. The government failed to prevent funds from being used to finance speculative activities (Dymski, 2010).

Policy can place restrictions on foreign capital investment in domestic assets (government securities and bank deposits) or on domestic capital moving abroad. As extreme measures to control market forces, the government may impose control over international transactions. If the government wants to have virtual control over foreign exchange, it can decide who they would like to distribute those foreign

† University of Huddersfield, Department of Strategy and Economics, West Yorkshire, UK.
☎. +44-1484-422-288
✉. k.u.siddiqui@hud.ac.uk

currencies, the advantage being that with such measures it can influence the markets. Capital control can provide greater options for economic matters and policies, especially fiscal and monetary policies (Dymski, 2010). The balance of payments can also be influenced by capital control measures.

Those in favour of capital liberalisation argue that capital will flow from the developed countries, where it provides low marginal returns, to developing countries where it is assumed that it is scarce, meaning that free capital movement would imply high marginal returns (Crotty & Epstein, 1999; Siddiqui, 2016a). They subscribe to the policy of removing foreign exchange controls in developing countries so that they can run large current account deficits. This means that capital account liberalisation was expected to delink investment from domestic savings. Following such policies was expected to increase investment in developing countries meaning that would have more capital, which would be greater than their domestic savings, and would invest more, and ultimately, they would have higher growth rates. As Maurice Obstfeld (1998) has noted,

> "economic theory leaves no doubt about the potential advantages" of capital account liberalization, which is also sometimes called financial openness. This permits the international capital market to channel world savings to their most profitable regions in the world. Those developing countries with has little domestic savings can borrow to finance investment, thereby could experience growth rates without requiring sharp increases in their own saving. However, Obstfeld also warns the possible risks of openness to foreign financial flows and concluded that "this duality of benefits and risks is inescapable in the real world" (Obstfeld, 1998:28).

The relationship between financial openness and economic growth is far from straight forward. Most surprisingly, the recent the IMF study (2016) has openly expressed scepticism about its earlier position on neoliberalism. The IMF study argues:

> "Some capital inflows, such as foreign direct investment-which may include a transfer of technology or human capital-do seem to boost long-term growth. But the impact of other flows-such as portfolio investment and banking and especially hot, or speculative, debt inflows-seem neither to boost growth nor allow the country to better share risks with its trading partners… This suggests that the growth and risk-sharing benefits of capital flows depend on which type of flow is being considered; it may also depend on the nature of supporting institutions and policies… Although growth benefits are uncertain, costs in terms of increased economic volatility and crisis frequency seem more evident. Since 1980, there have been about 150 episodes of surges in capital inflows in more than 50 emerging market economies" (Ostry, *et al,* 2016).

In fact, since the adoption of neoliberal reforms in the 1980s, the inflow of foreign capital into the economies of developing countries has risen sharply; however, not all of them experienced rapid growth (Siddiqui, 2014a). The adoption of a capital liberalisation policy did lead to a rise in growth rates in some developing countries, but exposed them to economic vulnerability and financial crisis. Those in favour of capital liberalisation suggest that this largely happened due to short-term inflows, which increase the risk of sudden capital flow reversals (Bonizzi, 2014). On the other hand, critics of this policy such as Feldstein & Horioka (1980) highlighted the difficulties of capital liberalisation, concluding that there is a high correlation between domestic saving and investment ratios. Other studies also found that most of the East Asian countries that have had high growth rates also had very high domestic savings and were net creditors, not net borrowers, and also had a current account surplus.

Capital liberalization is one of the most controversial aspects of modern political economy. The problem seems to be due not only to liberalisation rules governing inflows of capital but to those affecting portfolio capital investments, which is short-term and speculative. Here, we intend to examine why capital liberalisation has become so important to the economy of a country and why neglecting this or leaving it to market forces, has frequently led to economic instability in developing countries in recent years (Siddiqui, 1998). The experience of the Latin America and East Asian countries in the 1990s shows that those countries that made the effort to become financially more open and integrated, paradoxically witnessed higher levels of economic and financial instability (Ocampo & Stiglitz, 2008).

During the East Asian crisis of 1997, capital flows were seen as an important element in the currency and exchange rate crisis. Therefore, control of capital movements has been suggested as a means of supporting fixed exchange rates and avoiding speculative attacks on currencies. A 'developmental model' followed earlier in the East Asian countries meant governments undertook a number of independent policy measures to reduce vulnerability to global financial shocks (Wade, 1990; Siddiqui, 2016a).

The strategy of East Asian export-oriented economies has been to achieve higher domestic savings relative to investment. Policy intervention helps to maintain desirable exchange rates and competitiveness. At the same time the accumulation of foreign exchange reserves allows them to maintain the undervaluation of foreign exchange rate to stimulate exports (Siddiqui, 2016b).

There has been wide discussion concerning whether the East Asian crisis was due to "over-lending" and "over-borrowing", which might have been re-enforced by distortions in incentives or regulations. Commenting on the reasons for this crisis Arestis & Glickman (2002) note,

> "The most striking of these relates to the question of whether the source of the Asian crisis was endogenous or exogenous and the related issue of the coincidence or otherwise of financial liberalisation and financial crisis. A further crucial difference is that whilst [the conventional view] holds one group of actors or another to blame our Minskyan thesis incorporates all of them into an endogenous interpretation of the crisis" (Arestis & Glickman, 2002:255).

They argue that many developing countries lack the domestic savings and foreign capital that could help to finance their business activities. However, the proponents of foreign capital ignore the fact that certain types of foreign capital can provide long-term investment and business commitment, while other capital inflows might be short-term and less stable. When economic crisis hit these developing countries, capital rapidly left them for the safety of developed economies (Minsky, 1986).

The methodology followed here is derived from the aims of the study and comparisons of international statistics are used as the main means of addressing the research questions and the objectives of this paper. Analysing relevant literature, empirical studies, and existing secondary data is the only possible way to obtain macroeconomic data. These include data from official sources and from international institutions such as the World Bank, IMF, OECD and UNCTAD.

The study also intends to critically examine the wider issues related to the capital movements in the developing countries including their economic stability and sovereignty. Financial globalisation represents a very important development in recent global economy. In this current phase of globalization, capital is far more mobile than it ever was in the past. In fact, the colonial period was characterised by segregation in the world economy, despite free trade, and no legal means was in place to control the flow of capital from the metropolis to the colonies (Siddiqui, 2015a). However, despite the availability of low wages, capital did not move freely in the colonies, except in certain limited spheres such as mining, railways and plantations (Chang & Grabel, 2014; Siddiqui, 1989). The neo-classical model of perfect competition, with perfect information and perfect capital markets does not hold in the real world.

During the 1930s Latin America delinked themselves from the world's capitalist economies and began a policy of import substitution industrialisation and, as a result, experienced higher growth rates, allowing them to establish a manufacturing sector.

Another question arises concerning the evidence supporting the proposition? that capital liberalization would be good for developing countries, a policy which was imposed through 'structural adjustment programme' and 'globalisation' by the World Bank and IMF. The World Trade Organisation (WTO) also supports capital liberalisation and suggests that it is good for growth, as it provided more capital for investments. However, it does not provide any clear evidence that this is promoting economic stability in the developing countries (Crotty & Epstein, 1999).

In December 2015, WTO's ministerial conference in Nairobi explicitly discussed GATS (General Agreement on Trade in Services). During this meeting, as had previously been the case, it was obvious that the developed countries were keen to support capital liberalisation. In fact, in the developed countries services account for rising share of output and employment. In addition the manufacturing sector in these countries has generally become less competitive whilst the financial sector has become more significant and is dominated by the financial centres of New York, London and Frankfurt. Liberalisation in financial services was the most important element of globalisation, increasing the developed countries financial companies' access into the markets of developing countries. This was possible due to the removal of domestic capital control measures and the reduction in domestic financial regulation in recent years.

2. Capital Mobility, Current Account Surplus and Growth Rates

Those countries that have witnessed rapid growth rates also have a considerable positive current account. With the non-availability of foreign capital inflows, countries with current account deficits are forced to devalue, and as a result imports are more expensive and exports cheaper. Such policy measures are expected to lead to improvements in the balance of payments situation. The liberalisation of capital measures increases capital inflows, but may also lead to appreciation in exchange rates, as witnessed in many developing countries in recent years, which drove down their export demands and increased imports, leading to negative current accounts and currency crises. For example, in China in the early 2000s, the central bank intervened in the foreign exchange markets to keep *Renminbi* appreciation under control (Bond & Garcia, 2015). As Figure 1 shows, the relationship between current account surplus and growth rates has been positive.

In Figure 2, the upper left-hand quadrant shows current account deficits matched to capital account surplus as is often seen in text books. However, in the lower right-hand quadrant countries such as Russia and Nigeria show the problems associated with the 'resource-curse'. Such countries appear to have capital account deficits, which are financed by current account surplus. Periodic overvaluation may be caused by large inflows of foreign capital associated with their resource sector, a case of the so-called "Dutch disease", meaning a loss of competitiveness in their export sector. However, when the current account surplus is not available to finance capital outflows; this would mean mounting pressures for devaluation and currency crises.

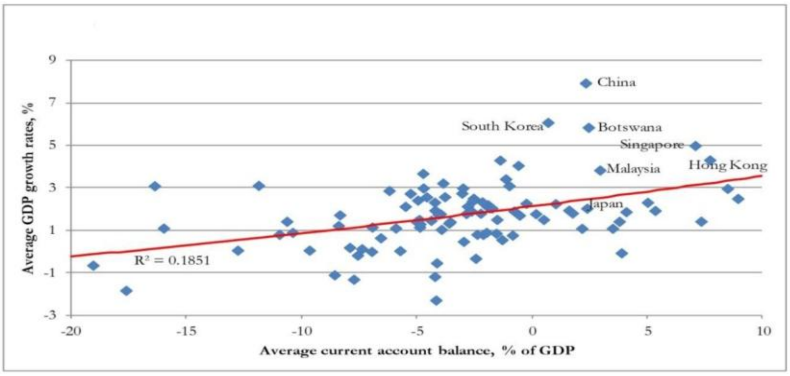

Figure 1. *Average annual growth rates of GDP per capita and average current account balance, 1970-2013*
Source: Calculations based on the World Bank, Development Indicators and IMF, Balance of Payments, various years.

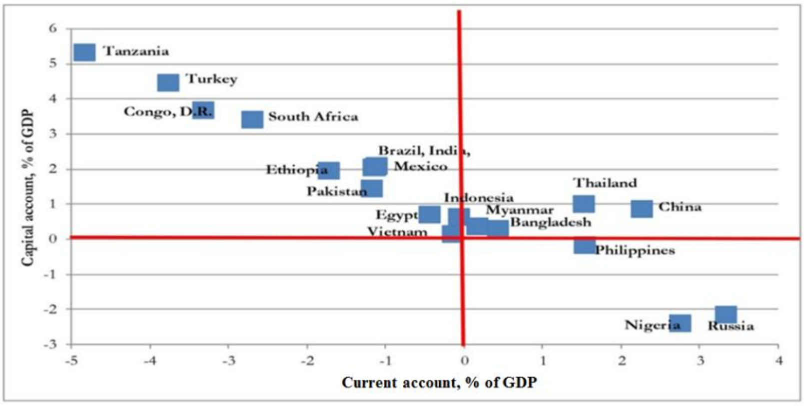

Figure 2. *Average current account balance and capital flows to large developing countries (% GDP 2000-2014)*
Source: IMF Balance of Payments; various years, IMF.

The UNDP (2013) report recommends a number of neoliberal policies such as further integration with the global markets, to adhere rules of global governance, and financial liberalisation. However, the report ignores the fact that increased dependence on foreign markets would mean increased vulnerability to the volatile nature of global finance, which has been in the recent past marked by speculation, capital flights, and economic crises. Such policies would run counter to the developing countries aim of economic sovereignty, and also pro-poor, and poverty alleviation goals of the economic inclusion agenda. As Soederberg (2015) argues:

> "[Financial liberalisation] has done little to deliver on the neoliberal promise of growth and progress through investments in production and thus the creation of stable and sustainable wages and, by extension, poverty reduction. Indeed, the increased frequency and intensity of financial debacles has made the South, and especially the poor therein, more susceptible to the aftershocks of speculative-led accumulation" Soederberg (2015:253).

There has been a rapid increase in capital flows in recent years due to gross inflows of private capital from nearly 6% of GDP in 1991 to more than double that amount in developing countries in 2013. This was an unprecedented development but at the same time it has made these economies more vulnerable to the perils of financial globalisation.

In the post-war period state control over cross-border capital flows was seen to be a very important policy measure within the macroeconomic framework. It was intended to ensure that the State could act without fear of triggering capital outflows, i.e. not having to be concerned about what disgruntled financiers, who might otherwise have taken their funds out, thought of its actions. The Bretton Woods system was introduced soon after the Second World War, allowing countries to have capital controls, and all of them had such controls in place. In the post-war period, capital control, both in the developing and the developed countries, was considered to be a normal part of policy measures, seen as essential government tools of economic management. Governments deployed capital control measures to enhance macroeconomic policies aimed at controlling and promoting financial and currency stability. In fact, this form of control was seen as a useful tool for promoting industrialization and competitiveness (Grabel, 2006).

During the period 2000-2007 in particular, developing countries received large capital inflows, fuelled by the availability of cheap credit in the developed countries and booming commodity prices (Bonizzi, 2014). The experiences of nearly two decades of crises including that of Mexico in 1997, East Asia in 1997-98, and Argentina in 2001, sparked discussions about the need for prudent measures to manage capital flows in developing countries. The cycle of boom and bust experienced by several developing countries necessitated a clear policy regarding how to deal with the capital inflows during the boom and how to respond to a situation of sudden and rapid outflows of capital during economic crisis.

The capital liberalisation of the last two decades has increased consumption and output variability. However, if capital inflows are dominated by the portfolio this could have adverse consequences for the developing countries. As Stiglitz (2004) argues,

> “Capital market liberalization [in East Asia and Latin America] has played a role in contributing to economic instability. Money rushed into the country, often financing a consumption binge, and then rushed out; as it left, financial institutions were weakened, often bankrupted, and exchange rates plummeted, leaving those with dollar-denominated debts hard pressed to meet their obligations. During the inflows, the exchange rate appreciates, posing problems for the import competing and export sectors. Some governments (Thailand in the mid-1990s) attempt to prevent this and at the same time, avoid the economy overheating; this necessitates cutting back on high-return public investment and raising interest rates […] During the outflows, financial institutions are devastated, and the lack of credit contributes to the economic downturn” (Stiglitz, 2004:63).

It would be useful here to re-consider the merits of two widely used economic formulations, namely the Mundell-Fleming “impossible trinity” and the Taylor Rule of monetary policy. According to Mundell-Fleming, a country can only have two of the following three: monetary sovereignty, a fixed exchange rate, and free capital flows. The Taylor Rule is bound by which a central bank adjusts its short-term interest rates based on the differential between a country’s potential and actual GDP, and between the inflation target and actual inflation. Developing countries may be constrained to respond to the external financial cycle, which could distort the Taylor Rule. In fact, if domestic growth concerns warrant low interest rates, a sudden fall in capital inflows may induce them to raise interest rates to attract foreign capital thereby exacerbating the downturn in the business cycle.

3. IMF Response to Capital Mobility Issue

The governments of developing countries are consistently told that capital control is impossible to enforce or too disruptive of normal global business relationships and may also encourage corruption. There is no doubt that IMF prescriptions in recent years have shown more flexibility than in the past when managing countries in crisis. However, the IMF still lends support to neo-liberal strategies and justifies this on the grounds that in the long term such policies will help developing countries. Overall its prescriptions on this issue have been incoherent.

In the wake of the East Asian crisis of 1997, many developing countries greatly increased their foreign exchange reserve so that they would a bigger cushion in the event of future crisis but this additional reserve is not being used to promote faster growth They also have to maintain higher rates of interests because under open capital market conditions; capital can leave the country en masse. Higher interest rates increase the cost of borrowing, which could discourage local businesses from borrowing and investing.

A few developing countries have imposed capital controls as a means of protecting domestic economies from the effects of global liberalised financial markets and in recent years the IMF has been less critical about such policies. However, this can be contrasted with its response when Malaysia imposed capital control during the East Asian crisis in the late 1990s. Then the IMF referred to this control of capital outflows as a backwards step and one IMF representative stated that 'foreign investors in Malaysia have been expropriated, and the Malaysians will bear the cost of their distrust for years' (cited in Kaplan & Rodrik, 2001:11). In December 2006, capital controls in Thailand were reversed after only a few days by its Central Bank when a military coup replaced the previous elected government and such measures immediately triggered massive capital flights from the country.

The Chilean government also undertook measures aimed at controlling capital inflows, requiring foreign investors to keep their investment in the country for at least one year, and a percentage of the investment to be placed in an interest-free deposit with the central bank. Such policies certainly can impact on short-term debt (Crotty & Epstein, 1999). When South Korea removed capital control on short-term foreign bank borrowing, but imposed restrictions on long-term capital inflows such as foreign purchases of stocks and foreign direct investments, large scale borrowing by their banks resulted in the 1997 East Asian financial crisis (Chang & Grabel, 2014).

Excessive short-term foreign currency inflows could take place because local banks may borrow a lot of overseas capital. In such circumstances, imposing capital control may help to establish the supervision and regulation of the country's financial system. Some argue that such provisions may be less effective in the long term, as investors and borrowers may find ways to undermine such regulations (Magud & Reinhart, 2006).

It is interesting to analyse Iceland's experience of financial policy, since the country was advised to adopt capital control as a short-term strategy. It was the first country to sign the Small Business Act (SBA) for Europe which is the EU's flagship policy initiative to support small and medium-sized enterprises (SMEs). It comprises a set of policy measures ranging from 'entrepreneurship' and 'responsive administration' to 'internationalisation'. To improve governance and entrepreneurship during the financial crisis in 2008, the SBA was the first financial rescue measure in the Western Europe since that of the UK in 1976. Iceland initially approached its Scandinavian neighbours for help and then Russia in 2008. When all these efforts failed, some Western European countries suggested that it should negotiate an arrangement with the IMF, which the country did in the late autumn of 2008. The SBA negotiation provisions recommended that Iceland should adopt stringent capital control measures, the deputy managing director of the IMF emphasising that it should make capital control an essential feature of the monetary policy framework, given the scale of potential capital outflows. Iceland initially imposed capital control prior to signing of SBA in October 2008 and the IMF recommended that it was a necessity to maintain financial stability (Reinhart & Rogoff, 2011).

In 1991, the Icelandic government began to adopt neo-liberal economic policies including privatisation of public assets. Stock markets and the housing sector experienced massive growth, and all these combined effects made Iceland's per capita GDP one of the world's highest by the 2006. However, in 2008 its economy collapsed, when the country's three largest banks were forced to declare bankruptcy, and its GDP shrank sharply.

Until the late 1980s, Iceland's largest banks were state-owned and as a result capital was rationed amongst different sectors and industries. The government fixed nominal interest rates, and the Central Bank of Iceland (CBI) was seen to be implementing government policies. However, banks were largely managed with the aim of benefitting political parties and market forces were introduced to break the stranglehold of the domestic economy. These steps were taken because state ownership of banks and other big businesses placed limits on the profit opportunities of the capitalist class in general and therefore, privatisation in the 1990s was seen as a good avenue for investors.

In the late 1980s, real interest rates were low and even negative for a long period in Iceland's government-owned banks. As a result, credit demands soared with banks allocating credit to favoured businesses. This resulted in inefficiencies in resource allocation and debts rose relative to equity.

4. Capital Flows and Monetary Policies

Monetary theory predicts that when the exchange rate is fixed, capital flows will equalise domestic and international interest rates, in a situation when monetary policy is losing its ability to influence domestic activity. Similarly Obstfeld and Taylor have supported the view that it is impossible to maintain free capital flows, a fixed exchange rate and an independent monetary policy at the same time (Williamson, 2007).

At the Bretton Woods Conference in 1944, where the new post-war economic policies were agreed, J. M. Keynes said the single most important achievement agreed was that all countries should have the right to restrict capital movements, provided that the restrictions were not aimed at restricting trade. Keynes strongly believed that the earlier crises, such as the Great Depression and the Second World War, owed a great deal to the volatility induced by free capital movements. Therefore, according to him, the benefits of trade would be at risk if countries were to remove capital control.

The US dollar is the dominant international currency. At present about three-quarters of the total global currency reserves are held in US dollars. The US has the biggest and most liquid capital market in the world but this is continuously maintained and supplied by US deficit financing. The US has also put all its efforts into encouraging the rest of the world to open their capital accounts and remove all impediments to the inflows and outflows of capital. In the name of neo-liberal reforms, all forms of social control of the markets are reduced (Siddiqui, 2009a, Zhang, 2009).

Another major discrepancy is that the macroeconomic policies applicable in the case of developed countries were too often recommended to developing countries, despite the fact that the economic structures, institutions and capital markets of the latter group are very different from those of the former Mishkin (2004). identifies the difficulties faced by developing countries as being weak fiscal institutions, weak financial institutions including government regulation and vulnerability to sudden variations in capital flows.

It is argued that financial integration allows domestic businesses in developing countries to borrow in anticipation of future incomes. Following such arguments led to the opening up of their capital accounts to international finance. However, it was soon realised that asset markets are different from goods markets, and in addition financial markets in developing countries are different from those in their developed counterparts.

On the issue of outward-looking industrialization policy, Sen (2007:293-94) argues that, "Japan and Korea had almost no foreign direct investment (FDI) flows, while others such as Singapore, and later China, had these in ample quantities… and the absence of any portfolio flows in the early stages of development. But the sharp contradictions in the fast growing economies of Asia, India liberalised both the current-and capital-account components of its balance of payments… this in spite of evidence showing that those who opened their capital accounts to anything more than FDI quickly landed themselves in trouble as in the Latin America". Malaysia undertook capital control measures in 1998 to prevent capital flight and increase its control over the domestic capital market and exchange rate value of its currency. The government adopted a number of measures in monetary and fiscal policies to address the domestic imbalances and to deal with the recession (Siddiqui, 2009b). Malaysia's control policies have produced a faster economic recovery, a lower reduction in employment, and a quicker turnaround in the stock market. Kaplan & Rodrik (2001) analysed how Malaysia was able to achieve this better performance and control capital flight in comparison to South Korea and Thailand. They found that unlike Thailand and South Korea where interest rates fell sharply, in Malaysia interest rates remained stable due to a ceiling of 2.5% points over the base lending rate. The Malaysian government was careful to target short-term speculative capital inflows, while insulating capital inflows. Malaysia recovered from the East Asian crisis more quickly and its exchange rates were stabilised, while those countries, which adopted the orthodox policies experienced a longer and deeper crisis. Malaysia's Prime Minister Mahathir Mohamed was criticised for going against the region's widely accepted liberalisation policies (Siddiqui, 2012).

With capital control the government in Malaysia can pursue its domestic economic policies without the worries of a balance of payments crisis. Speculative attacks in East Asia and Mexico were fuelled by large movements in inflows and outflows of capital. The Malaysian government set a limit on capital outflows in 1998 to help the economy and to regain financial stability.

Gallagher's (2014) cross-country study found that among the East Asian countries, those that had applied capital control were able to perform better. Similar results were found by the other empirical studies (Magud & Reinhart, 2006). The Malaysian response to the East Asian financial crisis of 1997 offers an interesting lesson since soon after the crisis the country witnessed a rise in state ownership, as large numbers of family-owned enterprises were merged into state-owned firms. The differences between President Mahathir and his deputy Anwar Ibrahim become open, resulting in the removal of Ibrahim in 1998. As a result, Mahathir consolidated his power and all those businesses seen to be close to Ibrahim lost government favour. The government increased its grip over the corporate sector and banks, and ultimately influenced lending and credit policies with further shifts towards government-owned companies. Capital controls were aimed at minimising the risks of exit by large-scale investors, currency conversion by domestic and foreign asset holders and the risks associated with cross-border derivate (Gallagher, 2014; Stiglitz, 2004). These measures were intended to enhance the autonomy of domestic policy and to insulate the domestic economy from crises in other countries.

However, the problem is the experiences of developing countries in the late 1970s, when the huge accumulation of liquidity in the banks based in developed countries led them to increase their lending and investment in the developing countries. Soon after the debt crisis in the 1980s, the East Asian financial crisis of 1997 and more recently the global financial crisis of 2008, all made it clear that capital deregulation could lead to the loss of domestic sovereignty in macroeconomic policy, leading to a balance of payment crisis, currency instability, and capital flight.

Financial deregulation has two elements: liberalization of international capital flows and deregulation of domestic financial systems. This has led to dramatic change in the financial sector. These changes have given rise to sharp rise in the financial speculation activities and also such development has strengthened the influence of financial in the economy. In fact, the deregulation and removal of control on international capital flows has created a situation where countries could run large current account deficits (or surplus). This also has opened the possibility of a debt-led growth model and as a result a consumption boom. A country's exchange rates are often seen to be determined by capital flows rather than trade balances. Capital flows have often financial motives and are pro-cycle. As Stockhammer (2015) emphasises that:

> "The deregulation of international capital flows has loosened external trade constraints. It has allowed countries to run larger current account deficits for longer periods... episodes of strong capital inflows (capital flow bonanzas) usually come with speculative bubbles on financial and property markets and typically end in recessions. Financial globalization has thus ironically increased the room for different developments across countries. Current account imbalances can be maintained for longer - essentially as long as markets trust the situation" (Stockhammer, 2015:943).

Financial liberalisation expands access to capital via greater inflow of capital such as foreign direct investment, portfolio flows and other types of capital movements. The developed countries also demand international standards on governing capital accounts, financial markets, exchange rates, accounting systems and banking operations (Siddiqui, 2015a). Another major difficulty with capital liberalisation is that it brings increased dependence on monetary policy of international financial institutions such as the Federal Reserve and the European Central Bank. Low interest rates can flood developing countries with liquidity, heightening the risks for their economies when a tightening policy is imposed. A sudden slowdown in growth rates in international economies may lead to political unrest and chaos, which is not of their making (Siddiqui, 2015b).

Hence in the age of global finance the issue of creditworthiness has become a matter of importance for governments and it may be seen as prudent to pursue only those policies that are approved or in line with global finance. Governments do not want to see sudden outflows and panic in the financial markets which may prove disastrous for the national economy (Epstein, 2005a). In fact, the liberalisation of capital's social obligations, such as priority sector lending targets and changes in differential interest rates, could have adverse consequences particularly for SMEs leading to a rise in unemployment (Siddiqui, 2014c). The government is obliged to defend large and global businesses and financial interests.

5. Experiences of Capital Liberalisation

After the global financial crisis in 2008 many developing countries imposed capital control with the aim to regulate capital flows, especially to reduce foreign capital going into speculation. This step was supposed to help to keep inflationary pressures and pressures on currency appreciation under control.

In December 2007, Taiwan imposed restrictions on capital inflows with the aim of minimising speculative pressures from overseas investors (Zhang, 2009). Similarly, in June 2015, Argentina imposed capital control and government charges of 6% were imposed on overseas investors. The experiences of Latin American countries in the 1990s tell us that the lack of macroeconomic balance-budget turned into current-account deficits. This suggests that inadequate regulation and supervision of the financial sector can have disastrous consequences.

It seems that the mercantilist strategy of the East Asian countries rather than the open capital account policy of Latin America is preferable for developing economies. India's capital account was opened to capital inflows on the grounds this would accelerate growth and investment, but its continuing trade deficit owing to the absence of real depreciation is a drag on the growth in income (Ghosh & Chandrasekhar, 2009). Moreover, foreign capital inflows have not led to an investment boom in India. Klein (2012:4) argues that "There may be political reasons that make it difficult to impose capital controls during booms". As the financial system is becoming increasingly integrated, it appears that the time horizons of FDI and portfolio capital investment are quite different. FDI is generally seen as long term while portfolio investment implies a narrower timespan.

When Aizenman & Pasricha (2013) analysed the macroeconomic causes of changes in capital control on capital outflows in 22 emerging economies, they found that these were: fiscal concerns, overheating concerns, foreign exchange valuation concerns, macroeconomic stability and financial stability concerns. They concluded that the decision to liberalise capital concerns was related to net capital inflows such as higher appreciation pressure in the exchange market, and the accumulation of reserves. The currency appreciation generated by an upsurge in capital inflows can decrease export competitiveness and have an adverse impact on the manufacturing sector and employment situation within a country. The national government can fight exchange rate appreciation by accumulating international reserves.

Epstein (2005b) defines financialization as,"The increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of domestic and international economics" (Epstein, 2005b:4). He further says that the predominant form of capital is financial capital, since the financial sector has displaced the real or productive sector, relegating it to a subordinate position. Financialization works differently in countries where the financial system is based on capital markets and banking structures, and in developing countries these systems are unlikely to converge with Anglo-American market economies. The export sectors of developing countries are not able to attain current account surplus and they may find it increasingly difficult to attract capital inflows to balance their external sector. Therefore, in such circumstances these countries have to offer increased financial returns to foreign capital investors and lower wages in order for foreign markets to compete in the world market (Epstein, 2005a).

Prior to the 1981 economic crisis, Mexico followed import-substitution industrialisation (ISI), which produced a deep crisis and led to the dismantling of the government's interventionist policies. Among the economic reforms adopted, the government began with a de-regulation programme aimed at introducing 'efficiency' into the banking sector and reducing government intervention in the financial sector. Later, in 1990, the globalisation of Mexico's financial system took place and its capital market was opened to foreign portfolio investments. Finally, in 2000, with the further implementation of NAFTA, which was signed in 1994, Mexico adopted financial innovation, creating the conditions for securitization activities and greater involvement of both foreign international banks and corporations. As a result, these foreign companies increased their control over the banking and non-banking sectors such as investment banks, insurance companies and pension funds (Levy-Orlik, 2014).

The major activity of the foreign companies operating in the Mexico's financial sector was to advance credits; however the availability of more capital did not benefit its economy. As Levy-Orlik (2014:113-114) notes:

> "The Mexican economy has not benefitted from greater access to credit. On the contrary, Mexico has the lowest ratio of credit to GDP (an average 14%) among Latin American countries. Small and medium-size businesses constitute an important sector that has reduced credit availability, partly because these businesses have little to no credit history or collateral and are therefore unable to guarantee payment in case of default. While the dynamic part of credit (channelled to households) has expanded, its share continues to be relatively small" Levy-Orlik (2014:113-114).

The manufacturing sector, which had an important role under previous ISI strategies due to the adoption of NAFTA and market policies, did not experience drastic changes. Despite the increase in exports in the post-NAFTA period, the export sector was unable to achieve a surplus. Analysis of the country's foreign trade deficit shows that the manufacturing sector deficit is higher than its total trade deficit. Despite the fall in overall investment spending, those manufacturing industries specialising in exports of high technology have done well, while the traditional manufacturing industries have experienced a sharp decline in exports. The high tech industries are based on the *maquiladora structure*, which specialises in assembling goods that have strong import content and thus, to increase exports, imports must go up (Levy-Orlik, 2014). In Mexico, the banking sector has experienced profound institutional changes as bank ownership was transferred to foreign corporations, who took advantage of oligopolistic banking structures to gain further control over this sector. During this period of financialization and capital liberalisation the inflows of foreign capital and portfolio have increased, but to attract this international capital Mexico had to offer higher financial returns than those available on the global financial markets.

Brazil increased its interest rates, as it felt it was necessary to stop capital outflows, which could have an adverse impact on output and employment. Despite removing tax on capital inflows in 2008, the Brazilian government re-imposed 2% tax on portfolio inflows in late 2009 (BCB, 2014). These were modest efforts, aimed at slowing down the appreciation of the currency in the face of capital inflows into the country (Ostry, *et al.* 2010; Sen, 2007).

In the 1990s Brazil began to accelerate the linkage of its financial systems with global finance. When Lula took over as president, he simply followed the measures taken previously by Cardoso's government to prepare the Brazilian economy to participate fully in global finances. Since the 2000s, efforts were made to ensure the country's close cooperation with global finances in order to offer high profits and it was realised that not trade but finance helped Brazil to integrate with the world economy. The Lula government took measures to consolidate the country's position as a provider of cheap assets in the name of attracting finances. This becomes much clearer, if we consider the interest on foreign payments. This amount increased from US$ 12 billion in 1990 to US$ 21 billion in 2002, then US$ 29 billion in 2005, finally reaching more than US$ 35 billion in 2007. Growth in portfolio investment has been impressive increasing rapidly from US$ 400 million in 1990 to US$ 8 billion 2002 and US$ 13 billion in 2007. (Kaltenbrunner & Painceira, 2015) and the stocks of productive and financial assets owned by the non-residential have grown rapidly (BCB, 2014). Brazil's exports remained technologically backward and insufficiently dynamic in terms of world trade, becoming increasingly dominated by the agrarian sector, minerals and steel. In these sectors Brazil has the competitive edge because of low wages and its abundant natural resources, especially land and water.

Thailand imposed capital control in May 1997 and the aim was to stabilise foreign exchange and dampen speculative activities, as it was viewed that using interest rates as a means to defend the bhat. However, soon it was found that government measures were not comprehensive enough to eliminate the speculative pressure on the *baht*. As Edison & Reinhart (2000) study on capital control of Thailand (1997) and Malaysia (1998-99) find different results for both countries. Their studies focused on economic performance, foreign exchange reserves and capital flows, which concludes that:

> "[It] emerges from our empirical work is that the controls used in Thailand did not appear to deliver much of what they were intended. By contrast, in the case of Malaysia, the controls did align more closely with the priors of what controls were intended to achieve – namely greater interest rate and exchange rate stability and more policy autonomy – although initially, at least, these measures did not prevent mutual funds from exiting the country… The results do suggest that the timing of capital controls and the types of controls that are plied might have something to do with the success of controls" (Edison & Reinhart, 2000:20).

During periods of financial crisis developing countries such as Brazil, Colombia, Indonesia, Malaysia, South Korea and Thailand have all used various capital control measures to control capital flows, especially short-term and speculative ones entering the country that could have had adverse effects on their economies in terms of asset markets and exchange rates. South Korea's currency, the *Won*, appreciated rapidly in 2008 and the government set a limit on speculative capital and levied an outflow tax on capital gains of foreign purchases of government bonds. In return for financial assistance from the IMF, Thailand and South Korea adopted neoliberal reforms meaning that fiscal spending was reduced and interest rates were adjusted in the line with market-determined rates.

An IMF study on capital control measures has provided some guidelines for member countries designed to minimise currency appreciation and asset bubbles during the 2008 international financial crisis (IMF, 2012). However, such recommendations were given under special circumstances. Ostry *et al.*'s (2010) study supported the policy of capital control to shorten the recession period. They also find that "such controls, moreover, can retain their potency even if investors devise strategies to bypass them […] the cost of circumvention strategies act like sand in the wheels" (Ostry, *et al.,* 2010:5).

After independence from Britain in 1947, India embarked on a policy of 'import-substitution', in which industrialisation with the state playing a leading role was the 'commanding height' of the economy (Siddiqui, 2014a). In 1969, India's then Prime Minister, Indira Gandhi, took a populist measure by nationalising fourteen commercial banks and a decade later, there was rising inefficiency in public sector organisations, which were allowed to borrow at high interest rates from these government-owned banks. All these strategies did not bring any long term solutions. However, in the 1980s, the Indian economy began to open up to foreign capital and envisaged a greater role for foreign trade. These market-oriented policies became more obvious in 1991, when India approached the IMF for a bail-out and in return accepted further implementation of neoliberal economic reforms that included opening up its economy for goods and capital, privatization of public industries and a roll-back in state involvement in the economy (Siddiqui, 2014b). However, with increasing economic crisis in the 1980s, India moved towards assigning a greater role to foreign capital and overseas businesses, and significantly eased its capital control policy. Growing criticism of government financial repression to improve the performance of the financial sector led to formation of the government appointed Narsimham Committee in 1991 which recommended relaxing the interest rate ceilings amongst other things. To increase competition, foreign and domestic banks were allowed to operate. Foreign capital inflows were encouraged and the companies were allowed to remit their principal, dividends and profits and sales proceeds (Siddiqui, 2009a).

Since early 1990s, the Reserve Bank of India (RBI) has moved towards market-oriented economic policies. Under such policies, issues related to the monetary transmission mechanism have gained increased importance (Siddiqui, 2009b). The central banks in developing countries take into account the foreign variables when setting their monetary policies. Often they have taken debts in foreign currencies, such as US dollars, and hence any default can make the situation worse than that of the central banks in these countries, so often the policy was to let the exchange rate fluctuate freely. Monetary policy in developing countries is constrained by the international banks such as Federal Reserve, the European Central Bank and Bank of Japan. Foreign trade is also primarily invoiced in US dollars; therefore, any drastic variations in exchange rates could have adverse effects on foreign trade. For these reasons, central banks in developing countries try to stabilise exchange rates without explicitly stating this. Since 2005, in India bank credit to the commercial sector has accounted for more than 70% of total domestic credit. The currency to deposit ratio has declined since 1999. It is also known that in India the bank plays a role in financial intermediation and that the non-financial sector lacks alternative sources of funding (Aleem, 2010; Siddiqui, 2015a). Compared to those of developed countries, India's capital markets are insufficiently developed. Thus, the central bank (i.e. RBI) stabilizes the exchange rate via interventions.

There may be a reason why capital account convertibility may not be in the interest of an economy such as India. This may be due to government fiscal deficit, public debt and the capability of the financial sector to handle outflows. The budget deficit could then be transformed into a current account deficit and could possibly cause large depreciation. Capital inflows (except short-term debt) have been liberalised, meaning that quantitative restrictions have been removed and there are no bars to repatriation of both principal and return on these flows (Ghosh & Chandrasekhar, 2009).

Since the early 1990s, RBI has adopted market-oriented monetary policies, and controls lending through its monetary policy instrument. Prior to 1996, it only used quality instruments to control the amount of bank loans and the priority lending instrument was to meet the lending target in line with the 'government's developmental goals'. However, since 1997 the RBI has used the price instruments to indirectly control the amount of bank loans but also uses priority sector lending targets.

India took further measures to control capital in mid-2007, which were aimed at reducing the volume of capital inflows and the appreciation of the Rupee, discouraging portfolio capital inflows and decreasing the volatility on the Mumbai stock exchange. Balin concluded that for various reasons these measures achieved very little. He pointed out that the majority of the government's stated goals were unattainable and investors were able to circumvent the capital control measures. During this period, corruption and favouritism was rampant within the RBI and securities and in practice the policy tilted in favour of large corporations (Balin, 2008).

Since the early 1980s, many developing countries have adopted measures of capital liberalization and these policies should be seen against the broader context of the global policy change in favour of market-friendly development strategies, also known in developing countries as the 'Structural Adjustment Programme', a policy recommended by the IMF and the World Bank (Bonizzi, 2014).

The ascendancy of finance has sought to reduce the autonomy of national decisions and control over monetary and fiscal policies. At present, developing economies are very vulnerable and the short-term capital flows that follow capital liberalization can lead to further economic fluctuations, inhibiting government ability to counter such tendencies that arise from outside sources (Crotty & Epstein, 1999).

The year 2015 was a difficult one for emerging markets, since not only did exports of goods and services decline but they even turned negative for some previously buoyant exporters. It was also a time when capital flow reversed the course. IMF data shows that net capital flows into developing Asia declined significantly in 2014, marking a shift from the previous boom period for emerging markets, especially those in Asia. However, it appears that 2015 was even more devastating for emerging markets across the world, including those in Asia. Figure 3 illustrates how serious the swings in capital flows were.

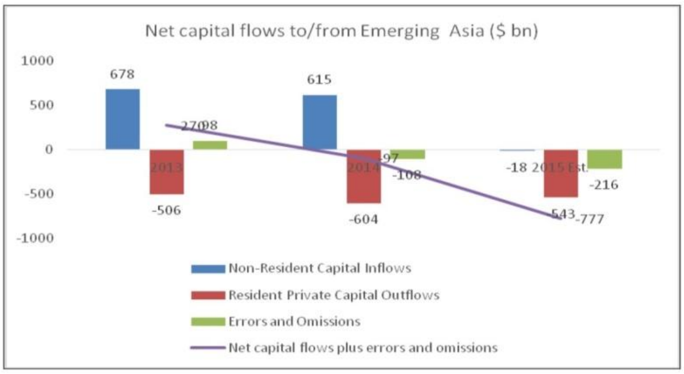

Figure 3. Net Capital Flows to/from Emerging Asia (US$ billion)
Source: IMF. 2016. Institute of International Finance, "Capital Flows to Emerging Markets", 19 January, IIF: Washington D.C.

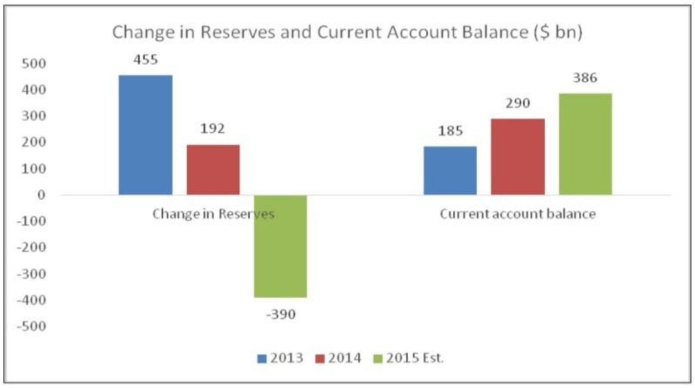

Figure 4. *Change in Reserves and Current Account Balance in Emerging Asia (US$ billion)*
Source: IMF. 2016. Institute of International Finance, "Capital Flows to Emerging Markets", 19 January, IIF: Washington D.C.

With the on-going global economic crisis, it is clear that capital flight from the emerging countries of Asia, for example, has risen sharply as shown in Figure 3. Taking the total of net inflows from non-residents into emerging markets across all regions minus the total of net capital outflows made by residents, and adding the effect of errors and omissions, the reports show a surprisingly large figure of US$ 735 billion net capital outflow in 2015, compared to a net outflow of US$ 111 billion for the previous year. Much of this was driven by China, where net capital outflow in 2015 amounted to US$ 676 billion, including US$ 216 billion in unrecorded net outflows. However, even excluding China, emerging markets as a group experienced negative capital flows in both 2014 and 2015 (IMF, 2016). With regard to the foreign exchange reserves in the BRIC countries between 1991 and 2015 (as shown in Figure 5).

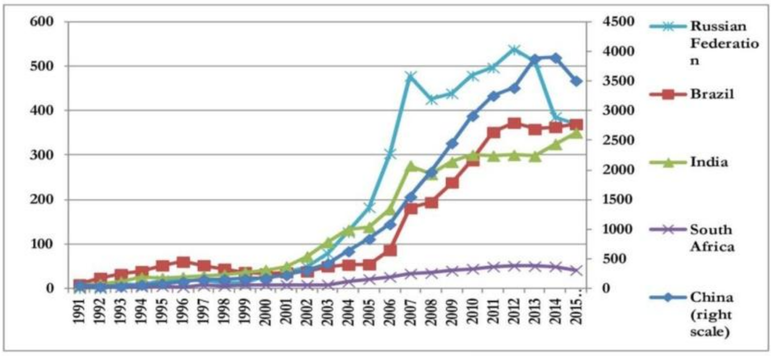

Figure 5. *Foreign Exchange Reserves of BRICS countries, US$ billion*
Source: World Bank, World Development Indicators; various years.

When we look at China's per capita income, the figure is quite impressive. However, despite the optimism and rapid growth in recent decades projected by a number of studies, as shown in Figure 6, the average per capita income is quite low among the BRIC countries compared to that of G7 countries. The GDP per capita does not reflect the differences in the cost of living, but increases in GDP per capita can indicate rises in productivity growth and also growth in the economy of a country. GDP per capita in India and China relative to US was as low as 3% in 1960. India's relative GDP was 3% of that of the US in 2010, but China's GDP per capita more than doubled to 8% for the same year, as shown in Figure 6.

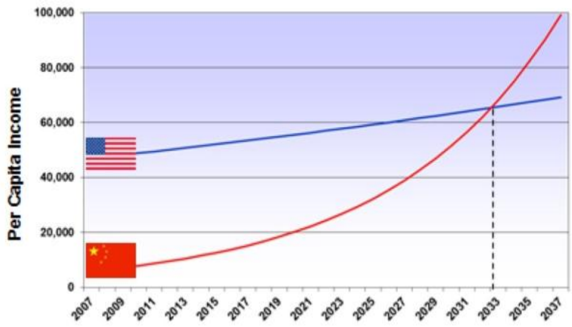

Figure 6. Per Capita Income Growth for China and US
Source: *The Economist*, 2015; OECD, 2015

The net capital inflows from non-residents to all emerging markets remained positive in 2015 at an estimated US$ 293 billion. However, the more significant factor was that residents of these emerging markets took their money elsewhere: net private capital outflows by residents amounted to as much as US$ 824 billion, and the trend was evident in terms of both foreign equity investment and lending patterns. Unrecorded flows in the form of errors and omissions contributed to this haemorrhaging, amounting to as much as US$ 206 billion. Figure 4 indicates the dramatic swings in the direction of net capital flows that have occurred in just three years. Net non-resident capital inflows into these seven Asian countries declined from nearly US$ 700 billion in 2013 to an estimated negative figure of around US$ 18 billion in 2015 (IMF, 2016).

The net inflow of US$ 98 billion in 2013 has become a net outflow of as much as US$ 216 billion estimated for 2015. Once again this is hugely driven by what is happening in China in terms of unrecorded capital flight – the IIF estimates Errors and Omissions in the Chinese balance of payments to be greater than US$ 200 billion in 2015. Figure 4 shows that the estimated current account surplus in China for 2015 is US$ 270 billion, but in fact of these Asian countries, only India and Indonesia showed a deterioration in their current account balances (which were already in deficit) between 2014 and 2015 (IMF, 2016). The other countries experienced slight improvements in their current account balances - but this did not prevent the substantial capital outflow.

The Minsky's criticism of capital account liberalisation directs us towards rent-seeking and speculation, which are expected to increase with the rise of cross-border capital flows in the developing countries (Minsky, 1986). It means that financial de-regulation could lead to financial instability. As Mitchell & Toporowski (2014) note:

> "[Financial] deregulation is deemed to be an exogenous policy choice imposed on developing countries at the behest of the International Monetary Fund for the convenience of international banks. This forced liberalization is supposed to be the key issue for the political economy" (Mitchell & Toporowski, 2014: 76).

In fact, in the developing countries, the capital market operates under more complex system of corporate finance including multinational corporations, public enterprises and relatively small number of domestic private enterprises, who are more vulnerable to foreign capital inflows (Levy, 2012).

6. Concluding Remarks

It is argued here that restrictions on capital mobility will enable developing countries to exercise monetary autonomy and stable exchange rates. In the face of the 2008 global financial crisis, India and China, for instance, slowed down their plans to liberalise their capital account (Siddiqui, 2010). India, like China, has not fully liberalised capital flows and short-term debt inflows in particular have remained under tight control. Even this did help them maintain stability during the global financial crisis of the 2008 (Siddiqui, 2015b). In order to reduce the frequency of financial crises, developing countries need to take measures towards controlling capital inflows. These could be applied by a number of methods such as to limiting inflows or prohibiting capital entry into the country.

Moreover, such controls might reduce the risk of financial crisis as they should prevent large inflows and also reduce excessive lending and short-term speculation and borrowing. Capital control is also expected to reduce the risk of sudden capital outflows if foreign capital decides to pull out of the country. If anything can be learnt from past experiences, these show that capital controls are important macroeconomic measures that a country can use to prevent and mitigate financial crisis. It seems that the essence of financial liberalisation is to ensure the stranglehold of finance over government control in developing countries, for although we live a world where countries remain nation-states, the reality is that capital is globalised (Chang & Grabel, 2014). The policies should be subject to broader debate and checks. Here is this context the question, what is the social benefit of capital inflows one that is directly addressed in policy formulations that then needs to be regulated, as Joan Robinson warned: “It is easy enough to make models on stated assumptions. The difficulty is to find the assumptions that are relevant to reality… Even if the crises that are looming up are overcome and a new run of prosperity leis a head, deeper problem will still remain. Modern capitalism has no purpose except to keep the show going… It should be the duty of economists to do their best to enlighten the public about the economic aspects of these menacing problems” (Robinson, 1971:142-43).

This study has found that financial liberalisation strengthens international capital; moreover, by assigning complete authority of the central banks, governments have little policy control over monetary and exchange rate. Increased power is transformed to bureaucrats and financiers who control international financial institutions. With the on-going global economic crisis facing the emerging Asian economies as a group, foreign exchange reserves declined by nearly US$ 400 billion, but not all countries showed the same trends in declining reserves. In China alone, the foreign exchange reserves are estimated to have declined by US$ 405 billion over this period, which is still a relatively small drop considering that at the start of the year the country held more than US$ 4 trillion of such reserves.

The study suggests that to protect the developing economies from the instability associated with the financial globalisation some degree of capital control is required. A new situation arises where during the sudden change in the international economy and it is important to know how to prevent shockwaves from affecting the economy. Those economies which are integrated into the international capital may prove to be at the mercy of external forces, in the absence of any control on capital and exchange rates. There is no doubt that in such circumstances capital control seems to be a useful tool for controlling capital movements and maintaining economic stability and sustainable growth in the developing countries.

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