# Privatisation in Bangladesh: Some Critical Questions

**by Syed Akhtar Mahmood**

***There is now a growing literature on this subject addressing several key questions: how have enterprises performed after privatization, has efficiency increased, has production gone up, and what has happened to the workers? The findings are mixed: while some enterprises have done well, others have not.***

AS in most developing countries, privatization is a much debated subject in Bangladesh. However, while many developing countries have moved fast, despite such debates, to privatize state-owned enterprises, Bangladesh has been relatively slow in privatisation. There is some irony in this for Bangladesh was one of the pioneers in this area. Long before Thatcher had made privatisation a household word, and long before the transitional economies initiated a massive experiment with divestiture, Bangladesh embarked on the path in the mid seventies, with significant privatisations in the early eighties.

The slow speed notwithstanding, a large number of enterprises, across several industries and of varied sizes, have indeed been privatized. What have been the results? There is now a growing literature on this subject addressing several key questions: how have enterprises performed after privatization, has efficiency increased, has production gone up, and what has happened to the workers? The findings are mixed: while some enterprises have done well, others have not.

One could debate the quality of the studies, the rigor of the analytic methods used and the appropriateness of the conclusions drawn. We could argue on what constitutes appropriate indicators of performance and how to evaluate performance changes when there are improvements in some dimensions and deterioration in others. Measuring performance is not easy; interpreting the measures is even more difficult.

It is thus no surprise that different people have read different things in these findings. Some see the specter of de-industrialisation in the fact that some enterprises have actually closed down after privatization. But others, noting that the closure of intrinsically inefficient enterprises actually benefits society by stopping the wastage of valuable resources, see this as a success of privatisation. Some look at the poor loan repayment performance of some privatized enterprises and conclude that privatisation was pre-mature; others, noting that the banks whose loans are defaulted are largely state-owned, argue for more privatization, encompassing both the real and the financial sectors. Some look at the poor tax payment record of some privatized enterprises and question the rationale for privatisation; others see a weak tax administration as the root problem and argue for greater privatisation, so that the government can concentrate on the really core tasks, such as improving tax administration.

The fact that some privatized enterprises in Bangladesh have done well while others have not should come as no surprise to those who have monitored post-privatisation performance elsewhere. Variations in performance are common, both across and within countries. Much evidence from middle- and high-income market economies indicates that the results of privatization are generally, indeed highly positive; but such gains are not immediately apparent in a number of countries, in particular those that were once part of the Soviet Union and a number of other low-income countries.

Here, the changes in ownership per se have not always led to the expected improvements, at least not fast enough. Problems faced by enterprises after privatization, and their spillover effects on the rest of the economy, have thus become a matter of concern and the debate is now focusing on how to deal with the post-privatization problems. Should this task be left to the market? Is there a role for government and, if so, what exactly is it? Should governments focus on further policy and legal reforms or should it also make arrangements for providing direct support to enterprises? In country after country, especially in the ex-socialist countries, policy makers and others are now debating these issues.

In Bangladesh too, we need to focus more attention on the post-privatization problems faced by enterprises. All this debate on privatization in Bangladesh seems to have neglected one important set of questions. If privatised enterprises are not doing well, why is it so? What is constraining their performance? What factors determine post-privatization performance? Answers to these questions will let us evaluate better what is needed to improve post-privatisation performance. Indeed, as many problems are common to all private enterprises, privatised or not, we will understand better what is required to improve performance of the entire private sector. Thus, if we are committed to private sector-led growth, it is urgent that we ask these questions.

Enterprises, privatized or not, often need to bring about changes in their operations. Declining demand for traditional products may require the elimination of obsolete product lines and the introduction of new products. Greater competition may demand improvements in product quality and a strengthening of marketing functions. The presence of surplus employees may necessitate retrenchment. An unsustainable financial structure may warrant financial restructuring, such as debt-equity swaps or rescheduling of debt. And improvements may be needed in the accounting and management information systems to enable better monitoring of enterprise operations. In brief, enterprises often require restructuring to remain competitive and survive, if not expand.

This is especially true for privatised enterprises. State-owned enterprises are usually slow at bringing about necessary changes in their operations; indeed this is a major argument for privatization. The result: they are often saddled with many of the problems mentioned above, such as excess workers, obsolete products, improper financial structures and lethargic marketing departments. For such enterprises, mere ownership changes will not mean much if it does not lead to the required restructuring.

As mentioned above, many privatized enterprises have improved performance, often through bringing about such changes, while others have not. Why do some enterprises change and others do not? To answer this question, it is useful to distinguish between three broad sets of determinants of enterprise restructuring: signals, managerial skills and attitudes, and the enabling environment. For effective restructuring, all three sets of factors are important; the absence of one may considerably dilute the effects of the others.

To initiate changes, enterprise managers need to get the signal that changes are required. Often competition provides strong signals. Increased competition, whether from imports or from domestic producers, often lead to reductions in sales, revenues and profits. This signals to the manager the need to do something: e.g., change the product mix, improve the product quality, strengthen marketing efforts or shed excess workers. If managers know that government subsidies will not finance losses, or that enterprise owners will not tolerate large reductions in profits, they will make an effort to identify the causes of falling profits and take remedial actions.

Empirical evidence supports this view. A recent study of Russian manufacturing firms by John Earl and Saul Estrin found a positive correlation between import competition and several enterprise adjustment indicators, such as labor productivity and introduction of new product lines during 1992-94. Similarly, a study of Polish industries over the period 1991-93 found that total productivity growth was faster in industries subject to greater import competition.

Managers will be much less induced to change when signals are absent or contradictory. This can be the case, for example, if state-owned monopolies or oligopolies are privatized with no change in the competitive environment. Not subject to the discipline of competition, owners and managers of such privatized enterprises will maintain business as usual. They may show good profits--thanks to their monopoly privileges -- but not necessarily improvements in efficiency.

Signals may also contradict each other. Enterprises facing competition may survive without improving efficiency if someone is bailing them out. In Bulgaria, for example, trade liberalization in recent years has intensified the competition from imports. And, yet, empirical studies do not document any significant impact of import competition on the performance of privatised enterprises. Why? Because while the Bulgarian government liberalized trade, it continued to provide subsidies to privatized firms and tolerated tax arrears and defaults on loan repayments to state-owned banks. Enterprises could thus survive despite losses induced by competition.

This is a classic example of one signal, i.e., increased import competition, being diluted by another, i.e., the provision of subsidies. By liberalising trade, government signaled enterprises that, henceforth, they will no longer enjoy a protected market and will have to face up to competition. But, by continuing to provide subsidies, it simultaneously gave the opposite signal, i.e., "Never mind if you cannot face up to competition; if you cannot sell your products and earn adequate revenues to pay your taxes and repay your loans, we won't force you to do so". Not surprisingly, Bulgarian enterprise managers spent little time on introducing efficiency-enhancing measures. Why should they, when it was more worthwhile lobbying the government for subsidies?

Strong and consistent signals are thus necessary. But they are not sufficient. Even when the signals are strong and clear, lack of managerial skills may prevent an enterprise from doing better. Realizing the need to expand markets is one thing. Effectively searching for new markets, assessing demand and aggressively marketing products is a different ball game. Many managers lack these as well as other skills, such as the ability to develop business plans, adopt and adapt modern technology, control quality and put in place modern methods of accounting and monitoring.

Sometimes the problems are cultural, arising from deeply-ingrained attitudes and practices. This has been a pervasive problem in the ex-socialist economies, most of which lack people skilled in managing firms in a market economy. The old system obviously did not help develop market economy skills and attitudes in managers. Deprived of decision-making authority, except in day-to-day technical areas, managers lacked self-initiative and entrepreneurial spirit. Since output was sold mostly through central marketing agencies, and the emphasis was on volume of production, not sales, managers neglected product quality. In enterprise visits in the ex-socialist countries, I have myself encountered many managers still obsessed with trying to expand production volumes with little clue on markets for their products.

Empirical studies are showing that improvements in managerial skills and attitudes do have a significant impact on post-privatisation performance. For example, a recent study by Simeon Djankov and Gerhard Pohl of the World Bank has found that, in Slovakia, firms with changes in top management performed better than firms which retained old managers. Another World Bank study of 192 Moldovan enterprises shows significant returns to manager training. Surveys show that managers attach top priority to training in marketing and sales, with accounting training and visits to enterprises abroad also being cited as useful.

Managerial skills are thus important, as are strong and clear signals. However, we see numerous cases where, despite strong signals and skilled managers, improvements in enterprise performance are insignificant. This is usually due to various hurdles in the environment in which enterprises operate. Hurdles may be created by residual government controls, such as restrictions on exports, requirements to maintain the existing line of business, and restrictions on sales of assets, entry of new businesses, and the hiring and firing of workers. Even where outright restrictions are not in place, government policies may effectively restrict managerial discretion. High taxes on proceeds of asset sales which discourage enterprises from selling assets is one example.

Unpredictable and poorly administered government policies also create problems. More than high taxes, frequently changing tax rates, arbitrary interpretations of tax rules and other harassment by tax authorities usually raise the cost of doing business and discourage restructuring. Lack of legal and economic information, including market studies and company diagnostics, could also be a problem. If enterprises have inadequate knowledge of existing laws and their interpretation, they could become vulnerable to the whims of government officials and prevented from implementing appropriate restructuring decisions. Inadequate economic information, whether enterprise specific, such as enterprise diagnostics, or more general, such as market studies, also constrain restructuring. These problems are compounded by the fact that, in many countries, support institutions, such as the consulting, accounting and auditing industries are underdeveloped. Where they exist, they mostly serve larger clients who can pay, bypassing small and medium enterprises. In many countries, even larger firms encounter such problems.

Finally, and this is no surprise, lack of financing often prevents enterprise managers from carrying out restructuring even if they had the incentives and skills to do so. Lacking risk-management skills, banks often resort to excessive risk-averse behavior, leading to inadequate supply of credit even to credit-worthy enterprises. Only a few well-known clients get loans, and credit decisions are based on the quality of collateral, not that of the project. Poor supply of foreign investment exacerbates the financing problems besides depriving enterprises of useful technical know-how.

The above discussion suggests one thing. It is important that, in Bangladesh, we move away from constantly debating whether privatized enterprises have done well or not, to diagnosing the reasons for less than satisfactory performance in some privatized enterprises. If these are not doing well, is it because the environment is not competitive enough, is it because government continues to bail out poor performers, is it due to lack of managerial skills, is it due to bottlenecks created by government policy and its implementation, or is it due to other factors? Once this diagnosis is done, we would be in a much better position to identify policy and other responses required to address the constraints.

The fact that some privatized enterprises have not done well is not enough evidence against the logic of privatization. It is more a signal that further reforms might be required and that, in most circumstances, privatization, especially partial privatization, is not sufficient.

*The author is with the Private Sector Development Department of the World Bank. This article is written in his personal capacity and does not necessarily reflect the views of the World Bank Group.*

# The Real Face of Financial Liberalisation

**An economy open to global financial flows tends to get caught in the mire of stagnation and lower social expenditures, both of which impinge adversely on the poor. This is what has happened in India. Prabhat Patnaik writes**

THE term "financial sector reforms" is a euphemism for "financial liberalisation" which the Bretton Woods institutions have been advocating for Third World economies, and which a host of them as well as former socialist countries like Russia have actually adopted. The essence of financial liberalisation consists in three sets of measures: first, to open up a country to the free flow of international finance; secondly, to remove controls and restrictions on the functioning of domestic banks and other financial institutions so that they get properly integrated as participants in the world financial markets; and thirdly, to provide autonomy from the government to the central bank so that its supervisory and regulatory role vis-a-vis the banking sector is dissociated from the political process of the country, and hence from any accountability to the people. To be sure, not all these measures are immediately contemplated or demanded, but they represent the ultimate goal of financial liberalisation, which may be ushered in by stages.

The Bretton Woods institutions contrast financial liberalisation with what they call "financial repression", that is, the regime which was erected in India in the post-Independence period. What this regime visualised was a subordination of the financial system to the perceived needs of economic development. To this end, interest rates were kept low; banks and financial institutions were required to hold government securities up to a certain per cent of their total liabilities (the so-called statutory liquidity ratio), permitting the easy sale and cheap servicing of public debt; credit was directed to priority sectors, including especially agriculture; the Reserve Bank was retained as a part of the government and hence accountable to Parliament for its actions; banks were nationalised to ensure that they did not shirk their social obligations and established branches all over the country; strict controls were exercised on capital flows into or out of the country; and of course a fixed exchange rate with no current or capital account convertibility was maintained.

There were no doubt problems with this regime, arising from the fact that the economy was experiencing capitalist development, and hence the credit needs of vast masses of small producers and even small capitalists could not be met cheaply from institutional sources. But within this overall constraint, the logic of the regime was to make the financial sector serve the needs of development, which, it was believed, necessitated its three main features, namely, its being anchored to the national economy and detached from world financial flows; its being obliged to give precedence to production over speculation for which it also had to observe controls on the price and direction of credit (not that speculation did not thrive but the objective of the regime was to control it); and its being accountable to the people via the government.

The purpose of financial liberalisation is to reverse all these features: to detach the financial sector from its anchorage in the domestic economy and to make it a part of the international financial sector; to make it operate according to the dictates of the market which means the end of cheap interest rates, of the regime of directed credit and of the distinction between productive and speculative credit needs; and to remove it from the ambit of accountability to the people. In short, the purpose of financial sector reforms is to make the financial sector an aliquot part of "globalised finance."

This, it is argued, would serve the development needs of the country better than the previous regime did, by attracting large amounts of foreign capital into the economy. This argument, however, fails to draw a crucial distinction, namely between capital inflow that adds to the productive capacity of the economy, and capital inflow that does not. Direct foreign investment (DFI), and that too not all of it but only a part of it, genuinely adds to the productive capacity of the economy. This is the DFI which locates production on our soil for meeting the global market or which produces goods essential for us but for which we lack the technology.

But DFI which produces goods for the home market that only supplant what is being already produced does not add to our productive capacity; on the contrary it causes an implicit form of deindustralisation. And all capital flows in the form of deposits or portfolio investments constitute short-term flows that are essentially speculative in nature which do not add directly to productive capacity.

Financial liberalisation is undertaken in the name of attracting the first kind of capital inflow, but, for a variety of reasons, it scarcely succeeds in doing so. First of all, the total amount of all DFI inflows to the Third World (other than China which is in a separate category) is limited; secondly, even this limited amount is declining in the wake of the East Asian crisis; thirdly, productive, that is, non-deindustralising capital inflows, are even more meager; and finally, all "liberalised" economies are chasing these meagre inflows. Under these circumstances, financial liberalisation scarcely gives a boost to productive capital inflows. What it does, however, is to expose the economy to the vortex of speculative capital movements, that is, to the flows of short-term finance in search of quick profits.

SUCH exposure of the economy has at least three very important consequences. First, it causes deflationary policies in general and hence slows down both the growth rate of the economy and the magnitude of increase in social expenditure. Secondly, it exposes the economy to severe episodes of crisis, such as were witnessed in Mexico earlier and in East and South-East Asia recently, and these, among other things, cause "denationalisation" (that is, passing into foreign hands) of key domestic resources and means of production. Finally, it abrogates sovereignty and undermines democracy.

Let us look at these issues seriatim. In a world where finance capital is free to move wherever it likes, the tendency for it, other things remaining the same, would be to move to the advanced capitalist countries from the backward economies. In other words, not only the finance capital originating from the advanced countries themselves but even the finance capital originating from the backward economies would tend to get concentrated in the metropolitan centres where capital feels that it enjoys greater safety, greater social stability, and less of a threat to its hegemony.

To counter this, therefore, the backward economies have to ensure that "other things do not remain the same", that is, have to offer blandishments to prevent capital from flowing out. These blandishments take the form, among other things, of higher real interest rates on average than those prevailing in the advanced countries. Financial liberalisation therefore is inevitably associated with an increase in interest rates compared to what prevailed earlier and with higher interest rates than in the metropolis. The increase in interest rates has an adverse effect on productive investment directly. It also has an adverse effect indirectly: it makes the servicing of public debt more expensive and hence squeezes the public exchequer, leading to lower public investment and, via the demand and supply constraints it causes, to lower private investment as well. The squeeze on the public exchequer also affects welfare expenditures adversely.

This squeeze could be averted if the government could raise larger tax revenue or could run a larger fiscal deficit. But in an economy exposed to free movements of finance capital, neither of these options is possible. Larger taxation of companies drives away capital, both productive and speculative; and larger indirect taxation is not possible when the government is committed to tariff reduction, which implicitly curtails the scope for excise duty increases as well (for otherwise there would be gratuitous deindustrialisation).

Likewise, larger fiscal deficit has to be eschewed because, apart from violating the injunctions of the Bretton Woods institutions, it frightens away speculators. For all these reasons, an economy open to global financial flows tends to get caught in the mire of stagnation and lower social expenditures, both of which impinge adversely on the conditions of the poor.

THIS is exactly what has happened in India. Despite the fact that financial liberalisation in India is still incomplete, the real interest rates in the post-liberalisation era are much higher than what prevailed earlier, and this is one of the major factors accentuating the fiscal crisis and contributing to the cuts in public investment and social expenditure. The argument is often advanced that higher real interest rates encourage larger savings and hence make possible a larger investment ratio without causing higher rates of inflation. In post-liberalisation Indian economy, however, the increased compared to what prevailed earlier, even as the inflation rate on average is, if anything, higher rather than lower. And yet the fiscal crisis has been aggravated, and public investment and social expenditures have been drastically cut, which only underscores the vacuity of the savings argument.

But this is not all. An economy that has undertaken financial liberalisation also becomes vulnerable to crises. When short-term funds flow in, they tend to cause an appreciation of the exchange rate, the consequence of which is to make imports cheaper relative to home production and hence lead to deindustrialisation. But if this is avoided through central bank intervention which supports the exchange rate by holding foreign exchange reserves, then that in turn enlarges liquidity in the economy, which is typically used either for an expansion of luxury consumption or for an expansion of investment in the domestic non-tradeables sector such as real estate, or for financing speculative booms in asset markets, especially the stock market.

When short-term funds begin to flow out, there is both a downward pressure on the exchange rate and a collapse of asset prices, which reinforce one another, and cause an avalanche of outflow. Efforts by the central bank to manage the foreign exchange market by raising the interest rate to induce short-term funds to stay or to come back, have very little effect, or even have the opposite effect of further enhancing outflows by aggravating the asset-market collapse. On the other hand, interest rate increases lead to a contraction of the real economy. Thus, while the inflow of short-term funds, generally, has little impact by way of increasing the growth rate of the real economy, the withdrawal of short-term funds does affect the real economy adversely. And while the inflow of short-term funds occurs over a period of time, the outflow can be sudden, concentrated, and extremely destabilising, causing acute misery to the people, as we have seen in the case of the East and South-East Asian countries.

This extreme and acute nature of the crisis, to recapitulate, arises for the following reason: each of the two circumstances we have mentioned, that is, the downward pressure on the exchange rate and downward pressure on asset prices, can trigger a capital outflow and hence precipitate the other. They therefore reinforce one another in unleashing an avalanche of capital outflow and adding to the intensity of the financial crisis, which necessarily spills over to the real sector. The crisis can be triggered by either sources, but, once triggered, incorporates both foreign exchange and asset markets which conjointly aggravate it to extreme acuteness. Opening the economy to the vortex of international financial flows, therefore, apart from generally keeping the economy deflated, exposes it to acute crises triggered either in the foreign exchange or in the asset market, by the caprices of speculators.

THIS is exactly what happened in South-East Asia. These countries had used short-term capital inflows for investment in the non-tradables sector. In particular a whole range of investment projects in real estate, in office buildings and in the expansion of financial services had been financed by domestic capitalists through short-term foreign exchange loans organised through domestic banks, after the onset of financial liberalisation. But when short-term funds began to be withdrawn, there was pressure on the foreign exchange market, and a rise in interest rates, under the advice of the International Monetary Fund, to counter that pressure. But this only resulted in a reduction of asset prices, an increase in the incidence of insolvency among the capitalists who had used borrowed foreign funds, and hence a threat to the banking system that had organised these loans; this caused an even larger outflow.

Financial liberalisation, therefore, was at the root of the South-East Asian crisis. To be sure, the earlier impressive growth performance of South-East Asia could not have been sustained in any case in the face of the slowdown in world trade. But these countries would not have got into such acute distress if they had not pursued a policy of financial liberalisation. This simple fact is sought to be obscured in various ways by writers emanating from the Bretton Woods institutions. Two favourite explanations of the crisis in these countries advanced by such writers run along the following lines: first, the crisis was caused because proper "norms" were not followed by the banks (this is often attributed to "crony capitalism", forgetting the fact that all capitalism is crony capitalism); the second explanation is that these countries failed to depreciate their exchange rates in time when their trade deficits were widening, and relied instead on short-term funds to finance widening current account deficits.

Both these arguments are vacuous: if free financial markets are supposed to be efficient allocators of resources, then they should have ensured that the exchange rate depreciated at the right time, and that banks that did not follow the correct "norms" did not succeed in obtaining funds from abroad. The fact that the markets did not ensure these suggests that the markets are not the efficient entities they are supposed to be, which undercuts the argument advanced in support of financial liberalisation.

As a matter of fact, precisely because of the operation of speculative forces the markets are not efficient allocators of funds. Precisely because of speculation, the actual movement of funds depends not on the so-called "fundamentals" but on short-run expectations of gains. And there is no way of knowing, except after the event, what should have been the correct price of foreign exchange or the correct amount of external funds inflow. The market is intrinsically incapable of distinguishing between speculation and enterprise. Hence the root of the crisis lies in financial liberalisation which engenders speculation. When the very agencies that advocate financial liberalisation tut-tut about speculation and pretend as if that is because of some local specificities of these countries, they are being dishonest.

The third important implication of exposing the economy to the vortex of international financial flows is that it undermines democracy and sovereignty. The essence of democracy is the pursuit of policies in the interests of the people. This of course does not happen in practice in societies characterised by class antagonisms, but even in such societies, the existence of democratic institutions acts as a check on the extent to which the people can be squeezed. An economy exposed to the free flow of international finance capital, however, is obsessed with the need to appease international financiers, to retain their "confidence": the thrust of policies in such an economy therefore, even in principle, is not towards serving the interests of the people but towards serving the interests of the speculators, which represents an inversion of democracy. The compulsion to serve the interests of international financiers at the expense of the people is reconciled with the fact of the existence of democratic institutions such as popular elections through several mechanisms: first, various efforts are made to attenuate democracy, such as the presidential form of government (under which, in Russia for example, unprecedented hardships have been inflicted on the people), or the removal of key decision-making from outside the purview of the political process (for example, the autonomy of the central bank). Secondly, and more pertinently, the objective constraints of such an economy make different political parties adopt the same economic programme.

THE reason for this effective restriction of choice before the people in the matter of economic policy lies in the objective situation of an economy with financial liberalisation, where losing the "confidence" of international speculators does indeed cause massive immediate problems for the people. In other words, within the confines of a financially liberalised economy, if appeasing the international speculators imposes hardships on the people, then not appeasing them also imposes, in an immediate sense owing to capital outflows, hardships on the people. Since bourgeois, or even social democratic, parties lack the political will to come out of the confines of such an economy, they have to choose only between these alternatives.

Transcending the confines of such an economy is far more difficult than not treading such an economy in the first place. In countries like India where financial liberalisation still has not proceeded very far, it must be ensured that it goes no further. The basic argument advanced in support of it, namely that it would accelerate growth through capital inflows, is invalid. On the contrary, the type of capital flow that it does expose the economy to is such that democracy is undermined, growth and social expenditures are cut, and the threat of speculation-engendered crises becomes pervasive. As against such a regime, the real alternative is to the dirigiste strategy of the Nehruvian kind lies elsewhere.

If land reforms, larger public investment and social expenditure financed by direct taxes on the rich, and decentralised decision-making by elected bodies constitute the core of an alternative development strategy, then the appropriate financial regime must be one that dovetails with this alternative strategy. Subordination of finance to the needs of production is an essential condition of growth. This is what underlay the Asian miracles and this is also what the Indian dirigiste strategy brought about. The problem with the latter was not this fact of subordination but the fact that the strategy itself was at fault. It has to be replaced by a democratic redistributive strategy, and the direction of financial reforms must be such as to serve such a strategy. In other words, what is needed is financial reforms in keeping with an alternative democratic strategy, not financial liberalisation.

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*Dr. Prabhat Patnaik is Professor of Economics, Jawaharlal Nehru University, New Delhi.*

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