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Financialization and the Developing world: Mapping the Issues.

Judith Tyson and Terry McKinley

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Financialization and the Developing world: Mapping the Issues.

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Abstract:

This research paper has focused on global cross-border trends in private capital flows, along with reviewing trends in trade, international reserves, external debt, remittances and ODA. The paper covers the general period between 1980 and 2013. Within private capital flows, it investigates FDI, Portfolio Flows and Financial Flows (net bank lending) and analyses the trends of these three flows over four periods: 1980-1990, 1991-2002, 2003-2007 and 2008-2013. It finds that during 2003-2007 there was a sharp upswing in cross-border private capital flows, coinciding with the general rise of the forces of financialization. This intensifying trend culminated in the global financial crisis in 2008. As a result, during the last period, 2008-2013, there was a sharp contraction in portfolio flows and financial flows. Among developing regions, Developing Asia fared the best during this period. However, Middle-Income Countries (MICs) were, in general, the hardest hit by the financial crisis and the volatility of private capital flows. This was due to the fact that such flows were highly concentrated in these countries. More recently, MICs have suffered from precipitous capital outflows as a result of the withdrawal (or planned withdrawal) of quantitative easing by central banks in the developed world.

Key words: foreign direct investment, portfolio flows, financial flows, net bank lending, financial crisis, external debt

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Acronyms

AFDB	African Development Bank
BIS	Bank for International Settlements
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
DC	Developing countries
ECLAC	Economic Commission for Latin America and the Caribbean
FX	Foreign exchange
GFC	Global Financial Crisis
GNP	Gross National Product
HIPC	Heavily indebted poor countries
IFI	International Financial Institutions
IADB	Inter-American Development Bank
LAC	Latin America and the Caribbean
LIC	Low Income Countries
MDB	Multilateral Development Bank
MDGs	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MENA	Middle East and North Africa
MIC	Middle Income Countries
NGO	Non-Governmental Organization
PAR	Portfolio at Risk
RCT	Randomized Control Trials

Acronyms

RDB	Regional Development Bank
SSA	Sub-Saharan Africa
SWF	Sovereign wealth funds
UNCTAD	United Nations Conference on Trade and Development

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Introduction

This paper is a contribution to Task #1 of the FESSUD EC FP7 project. This task is designed to 'map the changing global financial and monetary system and the changing role of developing countries therein'. Designated as Deliverable 6.03, this report complements the efforts of the first two deliverables expected from Task #1. Deliverable 6.01 constitutes a review of the literature on the 'changing role of finance in development' while Deliverable 6.02 focuses on 'scenarios for future global engagement'. Thus, in the division of labour among the three deliverables, Deliverable 6.03 concentrates on 'mapping the issues on financialization and development'. It is explicitly designed to empirically 'map' a wide range of flows between developed and developing countries, including, of course, investment flows (such as FDI and portfolio investment) and bank and nonbank financial flows. But it also places this examination within a broader context of trade flows and the accompanying build-up of international reserves, remittances, ODA and external public debt.

For developed countries, the period of financialization – defined as the period from 1980 to 2013[1] – was characterised by huge growth in the scale and depth of financial markets, leading to a dominance of finance within the economy. Such changes were facilitated by deregulation of both trade and finance and increasing globalization of both.
However, for developing countries, the period of financialization has been more varied and more complex as financialization and globalization have interacted with the structural transformation that these countries have been undergoing as part of economic development. Such structural transformation includes, in the real economy, shifting dominance from low productivity to high productivity sectors, with accompanying shifts in employment, and also includes the transformation of agriculture and the concurrent development of industry and trade. The role of the financial system in supporting such transformation – for which the academic literature is reviewed in Deliverable 6.01 -- is traditionally considered to be to efficiently mobilise and intermediate resources in order to share the attendant risk involved in pursuing the associated investment.
However, there has been a wide divergence in the success that developing countries have achieved in economic development, with some emerging as global economic powerhouses and others continuing to languish in poverty and underdevelopment. The factors that appear to distinguish successful developing economies encompass a significant number of macroeconomic and structural variables. However, a consistent theme in relation to the financial sector, and in the context of a wide variety of institutional and market structures, has been the ability of such countries to mobilise resources for investment through boosting savings rates and directing foreign capital to investment, and to ensure that such investment is directed towards "pro-development" activities, including boosting

[1] Data in the paper have been sought for the full period from 1980 to 2013. However, there are some limitations on certain data sources. This means that a shorter period has been used in some cases. These exceptions are noted in the various figures in the paper.

agricultural productivity, early and mid-stage industrialization and mobilising sufficient resources from both the public and private sector.
Furthermore, those economies that have been the most successful have, arguably, become increasingly less trapped in the core-periphery dynamics of a global financial system dominated by advanced economies and have become correspondingly important as active participants in an emerging multi-polar global financial system based on the rise of new financial hubs and more vibrant south-south dynamics.
However, the period of financialization has also been accompanied by major failures in financial- system development, including in countries where financial systems have remained underdeveloped because of low savings and investment rates, and those which, as part of the process of financial deepening, have experienced financial instability and crisis that have repeatedly stalled and impaired their economic growth. In addition, such crises have been invariably associated with the core processes of financialization, especially the liberalization and internationalization of global financial markets. This paper examines in more detail these trends in developing countries since 1980, including the integration of developing economies into the international financial system.
The paper begins with a general background review of macroeconomic trends in developing countries during the period of 1980 to 2013 and then focuses on each of these trends in more detail.

Macroeconomic Trends in Developing Countries

Macroeconomic conditions in developing countries were characterised in the 1980s and early 1990s by moderate growth and high inflation. However, after the early 1990s a period of seemingly benign macroeconomic fundamentals began for developing economies. In particular, GNP and trade showed steady and strong growth accompanied by low inflation. This was termed "The Great Moderation", which affected both advanced and developing economies (Bernanke, 2004). Indeed, by the early 2000s developing countries had achieved average growth rates of over 7% per year, compared to only 2.7% for advanced economies. Such historical convergence between developing economies and developed economies has been rare. Indeed, more common since the 1970s has been divergence between them (Ocampo et al, 2010). The relevant trends are illustrated in figure 1 below.

The trends highlighted in figure 1 are then differentiated by region in figures 2 and 3 below. In Developing Asia, growth was persistently strong, ranging from 6% to 12% from 2000 onwards, and even in the post-2007 period it averaged 6%. Also, inflation has been consistently low. But GDP trends were driven by the large economies of India and China, both of whom experienced strong growth rates.
By contrast, other regions struggled. Latin America experienced hyperinflation, which peaked at 466% in 1990, and also suffered from anemic growth. It lost a quarter of a century in terms of progress on poverty reduction according to the estimates of the UN Economic Commission for Latin America and the Caribbean (ECLAC). In sub-Saharan Africa there was also relatively high inflation, which peaked at 45% in 1994, and weak growth (Ocampo et al, 2010).

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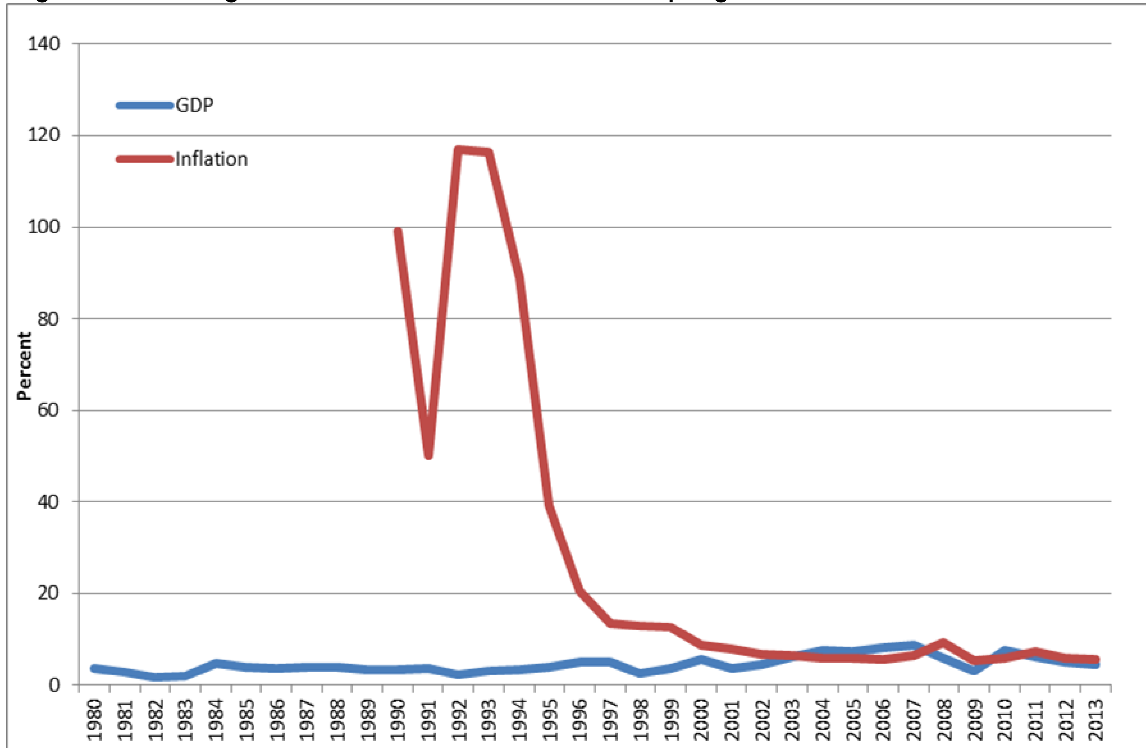
Figure 1: GDP growth and inflation in developing countries (1980-2013)



Source: International Monetary Fund, World Economic Outlook Database, April, 2014. (Note that there are no inflation data prior to 1990)

However, from 2000 to 2007, a wide range of developing countries experienced significantly improved macroeconomic conditions in parallel with advanced economies. But this pattern was periodically interrupted – as will be discussed – by periods of financial instability and crisis, including the global financial crisis. Nevertheless, the long term trends were generally positive until 2007.

The period of "The Great Moderation" was caused, according to some commentators, by international factors including financial liberalization. Specific finance-related factors that have been highlighted include improved monetary policy (Bernanke, 2004; Gregorio, 2008) and structural changes in financial systems. The latter included "the increased depth and sophistication of financial markets, deregulation ... increased openness to trade and international capital flows" (Bernanke, 2004). In relation to developing countries specifically, important causative factors that have been identified include cheap and liquid finance, booming international trade, based in part on high commodity prices, and large inflows of remittances following opportunities for international migration (Ocampo et al, 2010). These issues will be examined in more detail below.

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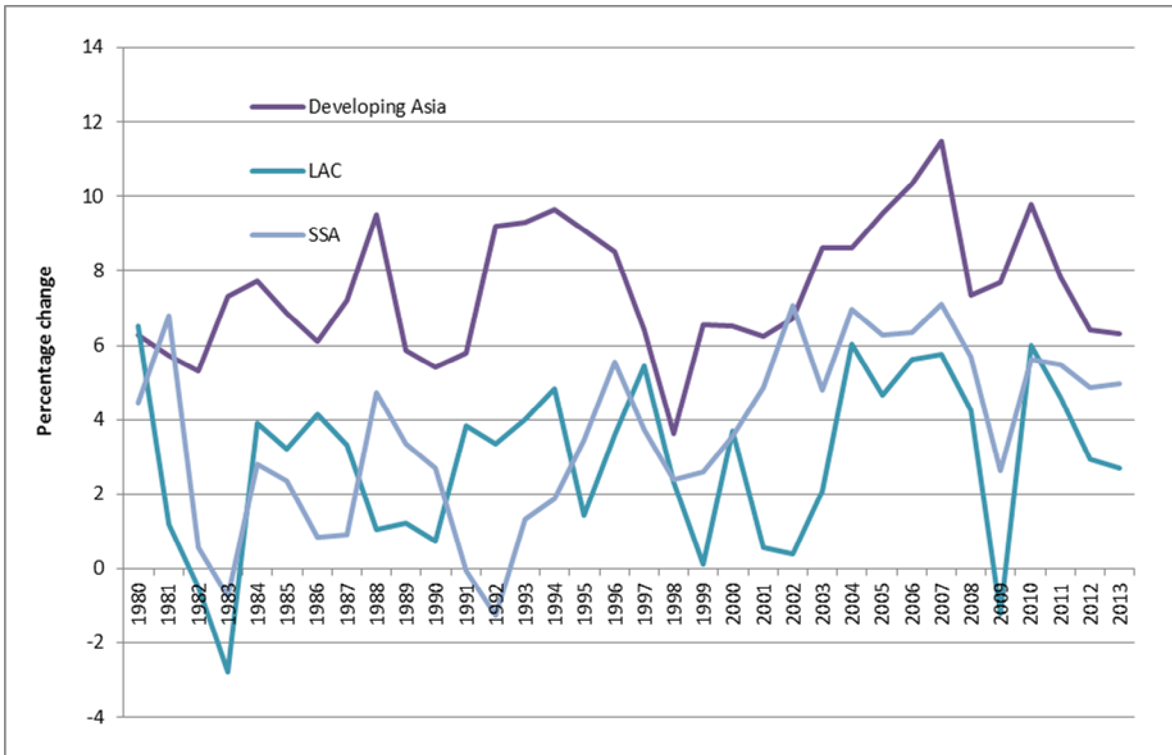
Figure 2: GDP growth for selected regions (1980-2013)



Source: International Monetary Fund, World Economic Outlook Database, April 2014.

Despite such impressive progress by developing countries, in mid-2007 the subprime financial crisis broke out in the US and had rapid contagion effects that enveloped economies linked to the US through the international financial system. Although in 2007 and early 2008, commodity prices boomed, helping the accumulation of foreign exchange reserves in commodity-rich countries, by 2008 the bankruptcy of Lehman Brothers led to a financial shock that caused the worst financial crisis since the Great Depression and the worst collapse of international trade in history. Termed the "Great Recession", it impacted mainly advanced economies. But many developing economies with vital linkages with and dependencies upon both international trade and finance were also gravely exposed.
Strong counter-cyclical policies were implemented in both advanced economies and some developing countries, notably China, in the face of such a crisis. Such measures helped prevent the repeat of the Great Depression (Ocampo et al, 2010) but since 2009 global growth has been subdued, including a moderation of growth in developing countries towards the 5% range (Source: International Monetary Fund, World Economic Outlook Database, October 2013). It is now broadly recognized that the major root of the crisis was excessive confidence in the capacity of financial markets to self-regulate and self-correct in the face of major disturbances and loose monetary policy. This trend was reinforced by the lack of meaningful regulation of financial systems.

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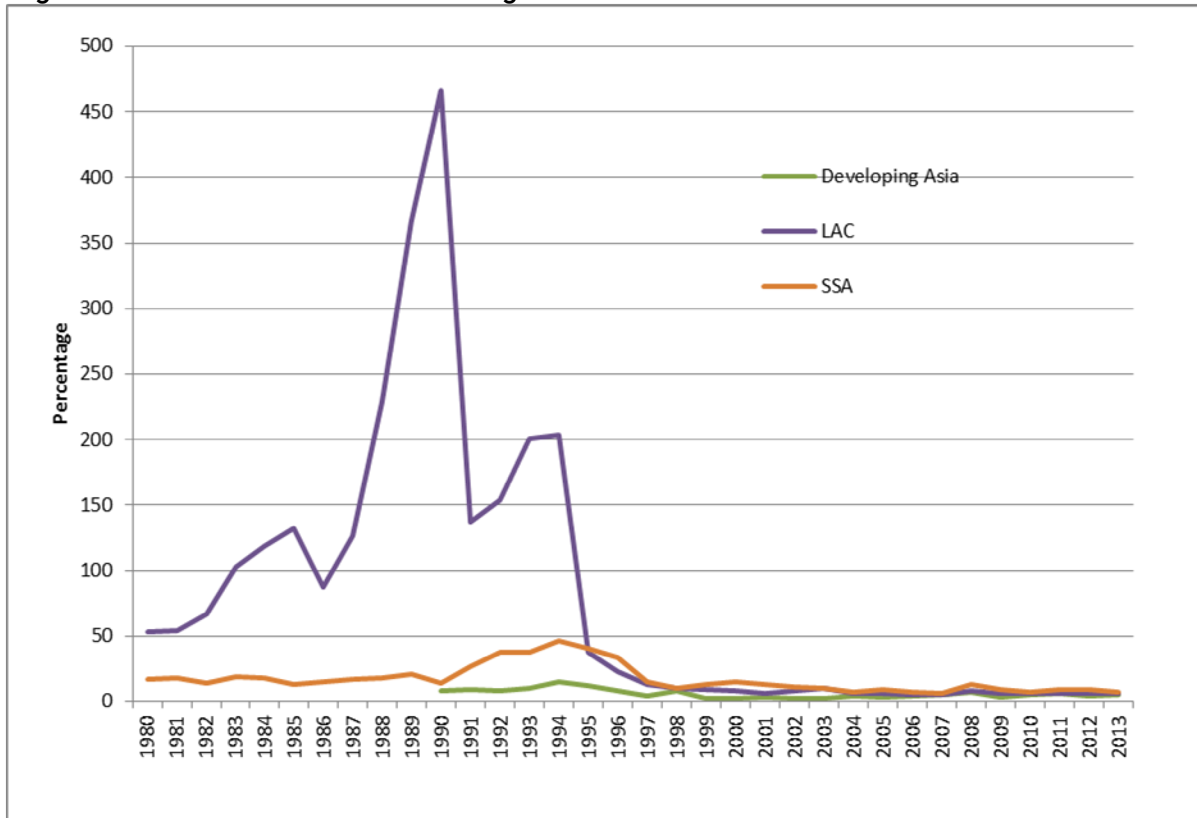
Figure 3: Inflation for selected regions (1980-2013)



Source: International Monetary Fund, World Economic Outlook Database, October 2013. (Note that there are no inflation data prior to 1990 for Developing Asia)

Trends in Financialization in Developing Countries (1980-2013)

Mobilising Domestic Resources

A core function of the financial system is to mobile savings and to channel it into investment for economic growth and development. Establishing a domestic financial system that can perform these essential functions for developing economies is emphasised not only in economic theory, but also in policymaking. For example, the Monterrey Consensus and the Doha Declaration, the World Bank and the AFDB all emphasize savings mobilization and investment as essential to successful economic development (United Nations, 2013).

Savings and investment have exhibited strong but divergent trends since 1980 between developed countries (G7) and developing countries (DC). As illustrated in figure 4 below, savings and investment rates in developing countries have accelerated since the late 1980s, but those in advanced economies have declined. In fact, after broadly stagnating from 1980 to 1998, there was a sharp acceleration in savings and investment rates in developing countries from a range of approximately 20-25% of GDP to a peak of 33.6% for savings in 2008 and 32.9% for investment by 2013.

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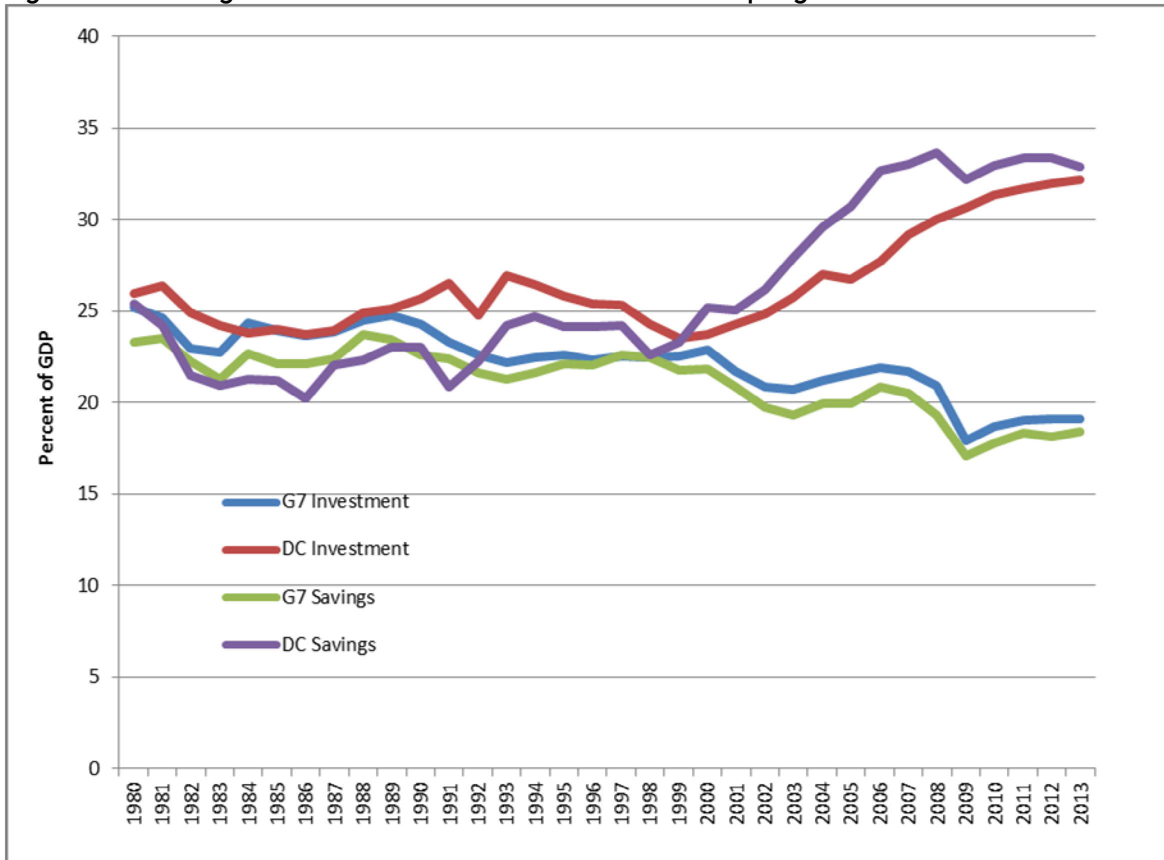
Figure 4: Savings and investment in G7 and developing countries (1980-2013)



Source: International Monetary Fund, World Economic Outlook Database, April 2014.

However, this positive picture of growth in the transformation of savings into investment is differentiated by region. As shown in figures 5 and 6, Asia has dominated these trends in both savings and investment and in the steady growth trajectory of these measures. Within Asia, a deeper analysis shows that these trends have been driven largely by China and India, which reached in 2012 savings levels of 51% and 31% of GDP respectively (Source: World Bank Economic Indicators, October 2012) and investment levels of 48% and 35% of GDP respectively (Source: IMF World Economic Outlook Database, April 2014). These levels were amongst the highest in the world. However, these trends contrasted, for example, with average savings and investment rates in 2012 for sub-Saharan Africa of 19% and 22% of GDP respectively (Source: Source: International Monetary Fund, World Economic Outlook Database, October 2013.).

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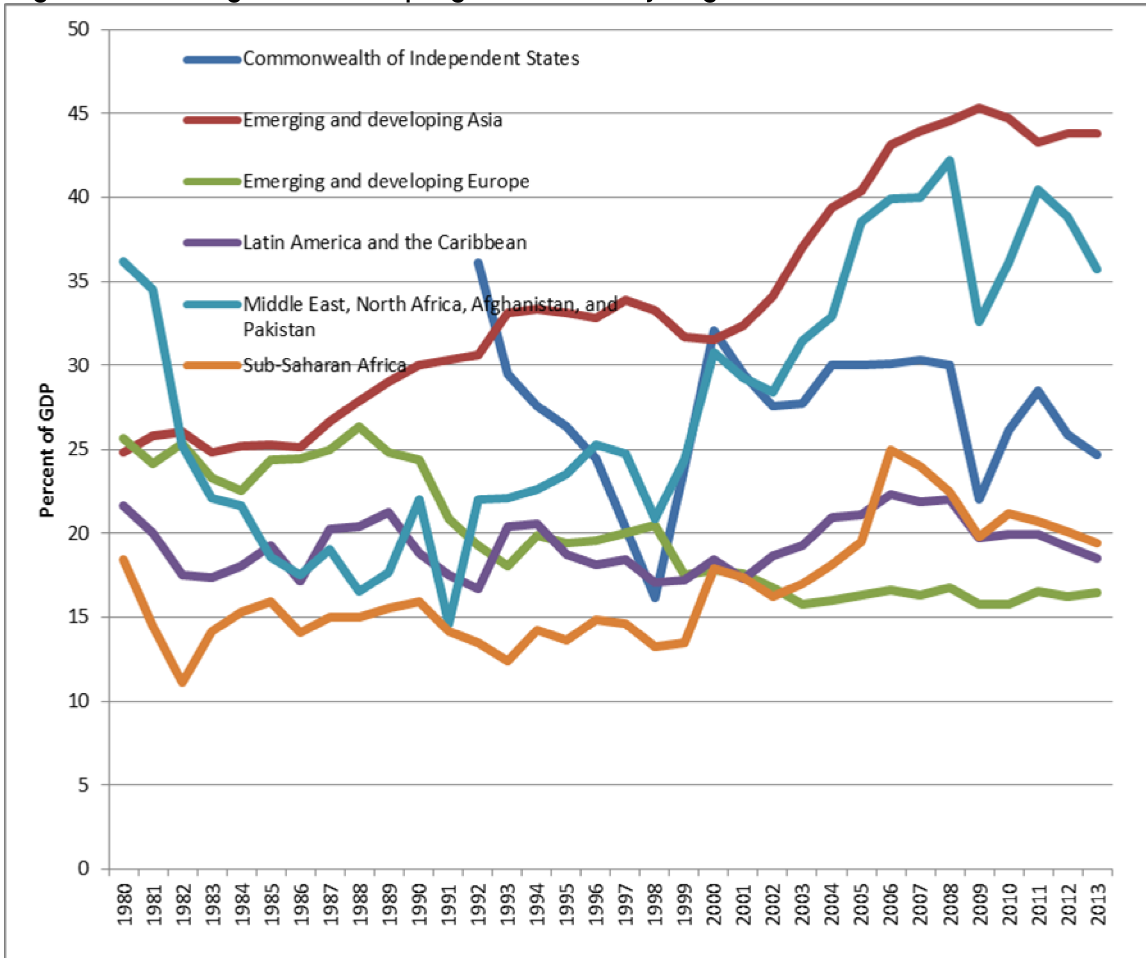
Figure 5: Savings in developing countries by region (1980-2013)



Source: International Monetary Fund, World Economic Outlook Database, April 2014.

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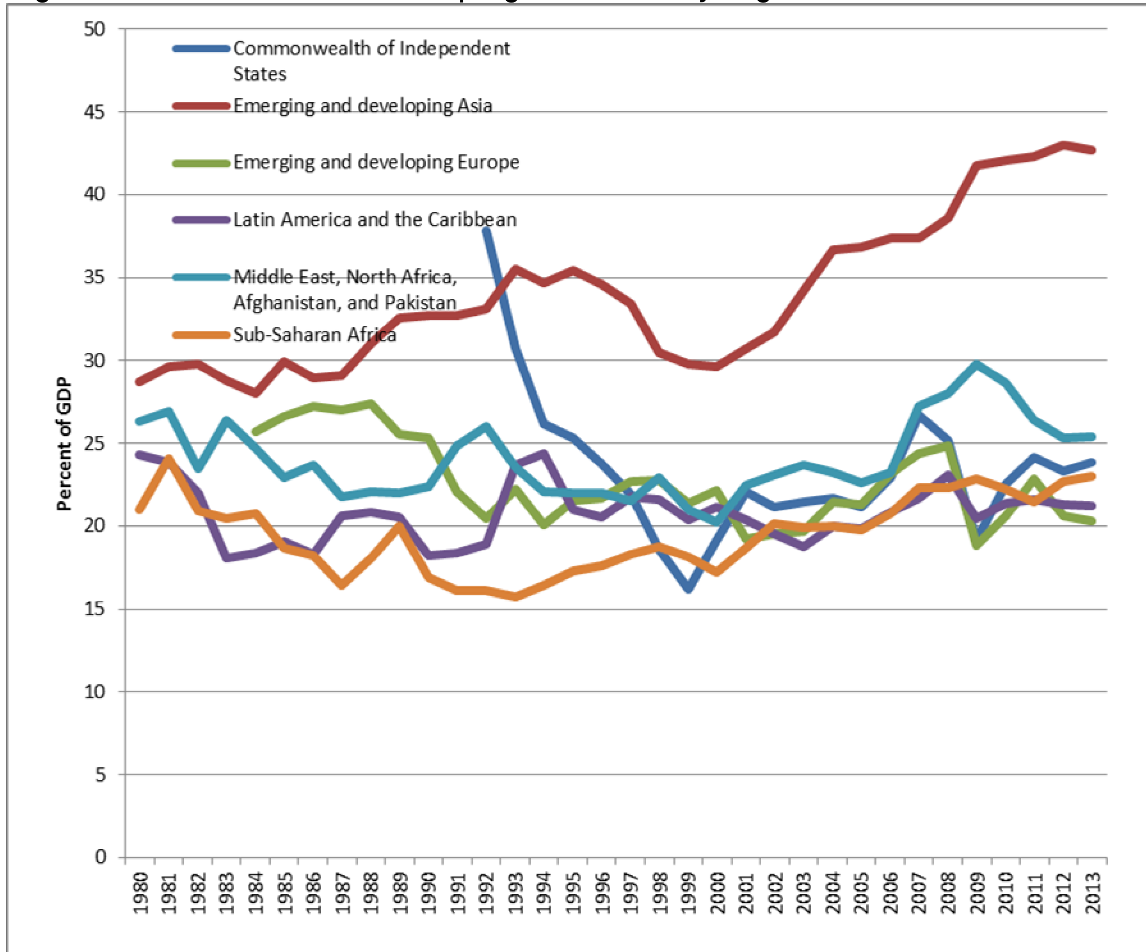
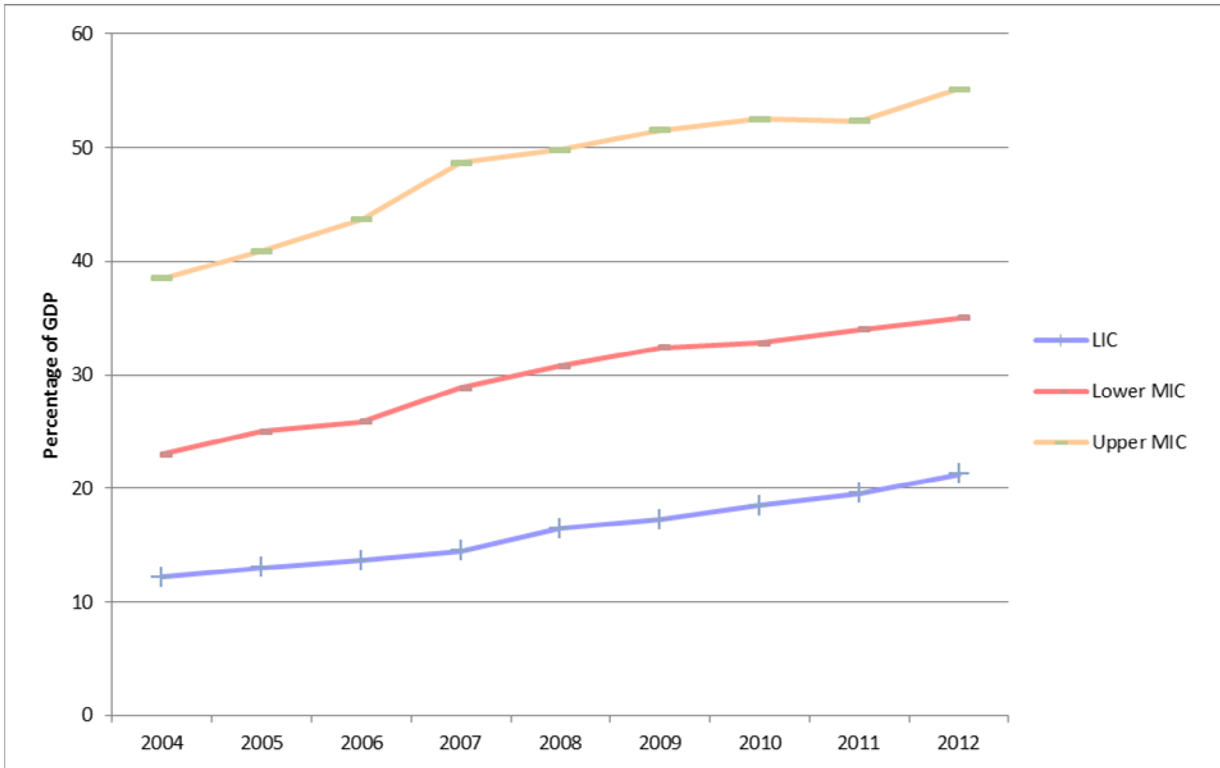
Figure 6: Investment in developing countries by region (1980-2013)



Source: International Monetary Fund, World Economic Outlook Database, April 2014.

In addition to the phenomenon of higher levels of saving and investment, financial sector deepening has been an important trend. It can be defined by growth in intermediated funds, which can be broadly measured by the level of private sector credit as a percentage of GDP. Private sector credit includes non-savings sources of private sector financing and credit, including foreign sources. As can be seen in figure 7, domestic credit growth in developing countries has been strong, but has been correlated with the per capita income levels of countries. For example, Upper Middle-Income Countries have had higher levels of private domestic credit than both Lower Middle-Income Countries and Low-Income Countries (LICs).

Figure 7: Domestic credit provided by the banking sector by per capita income classification (2004-2012)



Source: World Bank Economic Indicators, October 2013. (Data only available for 2004 to 2012)

Furthermore, as shown in figure 8, this trend was dominated again by Asia, primarily China and India, with poorer regions such as sub-Saharan Africa and South Asia having much lower levels of private sector credit, i.e., lower levels of financialization of their economies. Nevertheless, all regions still showed increasing trends for private sector credit.

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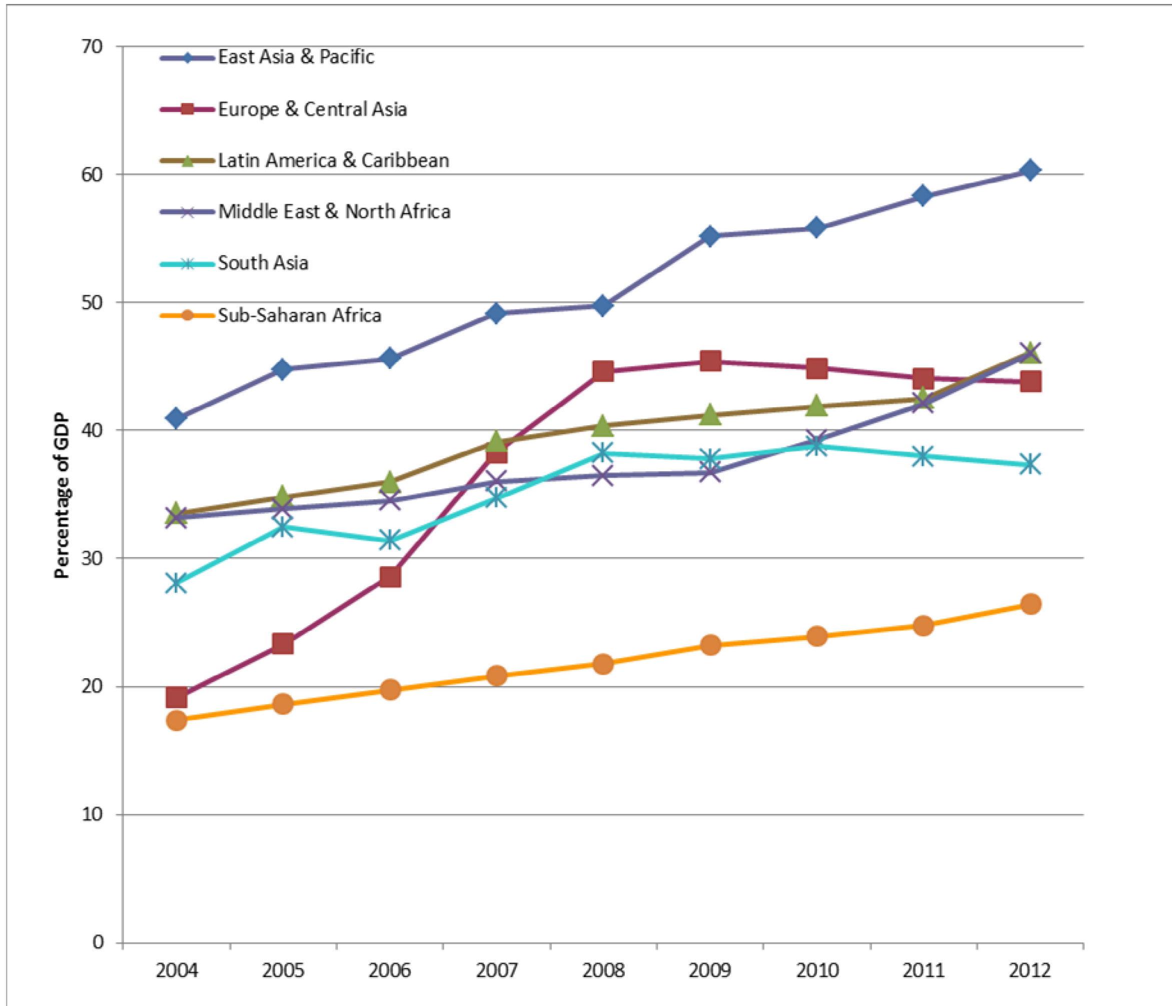
Figure 8: Domestic credit provided by the banking sector by region (2004-2012)



Source: World Bank Economic Indicators, October 2013. (Data only available for 2004 to 2012)

These comparative levels of private sector domestic credit reflect not only the level of economic maturity of a country but also the structure of its financial system. However, there is not a simple relationship of such credit with either of these two factors. The literature on the relationship between financial sector deepening and economic growth is reviewed in an accompanying FESSUD paper but it is widely agreed that there is an empirical – but not necessarily causative – relationship between the two. As will be discussed in the following sections of this paper on the basis of specific examples, there also appears to be a relationship between financial sector deepening and financial fragility associated with increasing credit relative to GDP. The reason seems to be that although high levels of intermediation can provide valuable funds for investment, they can also attract and intermediate speculative flows from both domestic and international sources that can have a destabilising effect (United Nations, 2013).

However, there is also a wide variance in the structure of financial markets, such as in the relative importance of bank lending versus capital markets, the degree of government versus private sector ownership and control and the breadth of financial access. For

example, some developing countries have been successful in developing financial systems that have been characterised by state control and ownership, including of savings institutions and banks, and by relatively low levels of capital market development. State involvement has included development banking and directed credit programs. These have been the stylised cases, for example, in China, India and Brazil and early-stage industrialising Japan. These characteristics contrast with conditions in today's advanced economies. For example, private debt securities in 2012 represented 34% of GDP in high-income countries compared to only 9% in MICs and almost nothing in LICs (UN, 2013).

It is proposed by some commentators that financial sector development consists of a progressive transition to private ownership of financial institutions and private capital markets compared to state control and public bank lending (see, for example, United Nations, 2013). However, some developing countries that have implemented policies of liberalization and privatization – initiated, for example, in many LICs in sub-Saharan Africa under IMF structural adjustment programs -- have experienced little deepening in their financial systems and/or slow economic growth (Nissanke, 1999; Ndung'u and Ngugi, 1999). Given the varied experience of these countries and the effects of the recent financial crisis, there appears to be an ambiguous relationship between greater levels of liberalization and higher levels of private credit, on the one hand, and faster economic growth and more financial stability, on the other.

Deepening of the financial sector has also often been associated with a broadening of financial access. For example, in high-income countries 90% of adults have a bank account compared to 57% in Upper MICs, 28% in Lower MICs and only 24% in LICs, as of 2012 (United Nations, 2013). However, again, the relationship between increased financial access, economic growth (especially pro-poor growth based on a higher trend of employment creation) and financial stability remains ambiguous and under-researched. Indeed, although some findings suggest that increasing financial access is associated with consumption smoothing for the poor, other research has found no consistent impact on measures such as medium-term improvements in average household income (Rosenberg, 2010) (Roodman, 2010) or business income (Banerjee, 2009; Kaboksi and Townsend, 2010). In addition, studies that have explored the relationship between the growth of financial access and economic development have found little correlation. For example, a study by Banerjee and Duflo (2001) found that in Bangladesh, where approximately one out of four households had at least one microloan, microcredit seems to have had little impact on the country's development performance. These studies can be easily criticized since, clearly, many other factors, and probably much more important ones than microfinance, are related to broad economic development. Nevertheless, these studies leave open the question about whether financial access plays any significant role in broad economic development. In addition, research has suggested that where institutions serving the poor in developing countries have become systemically important, the inherent fragility in the quality of their credit, because of lending to the asset-poor and income-poor, can contribute to overall financial fragility (Tyson, 2014).

Mobilising Private Capital Flows

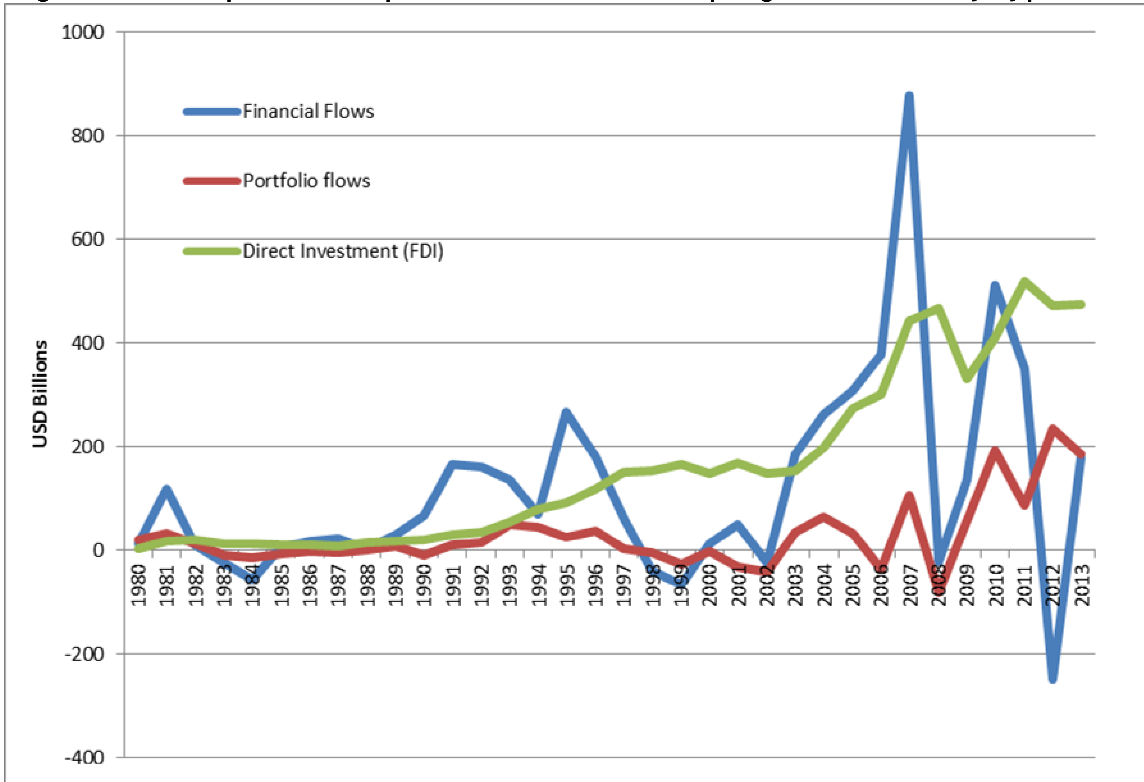
As previously noted, the period of financialization has been characterised by the internationalization of the financial system and the integration of developing economies into it. Such a system has been facilitated by the liberalisation of markets, especially of capital flows. Cross-border private capital flows have been regarded as important for development, given the scale of capital required for this objective. For example, their importance has been reiterated in both the Monterrey Consensus and the Doha Declaration (United Nations, 2013). They have also been regarded as a hallmark of financialization.

Cross border private capital flows are composed of several items. Foreign direct investment ("FDI") is the major flow to developing countries and is generally considered to be the most desirable for development purposes since it has the potential to provide a stable and long-term source of investments funds. But cross border private capital flows also include 1) portfolio flows, composed of equity and bond flows of various investor types[2] and 2) financial flows, which are primarily net bank lending. Both of these flows are considered less desirable as they can be short-term in nature and volatile. In addition, derivatives can play an important role in local foreign-exchange markets and money markets, including by exerting pressure through dollar-settled offshore markets.

As can be seen in figure 9, there has been a long-term trend towards increased cross-border capital flows. However, there have been significant differences in the levels of such flows by their type. Broadly, four periods of financialization can be differentiated (see figure 10). These four periods are discussed below.

[2] This includes, for example, pension funds, mutual funds, insurance companies, hedge funds and commercial banks (IFF 2013).

Figure 9: Net private capital flows to developing countries by type (1980-2013)



Source: International Monetary Fund, World Economic Outlook Database, April 2014.

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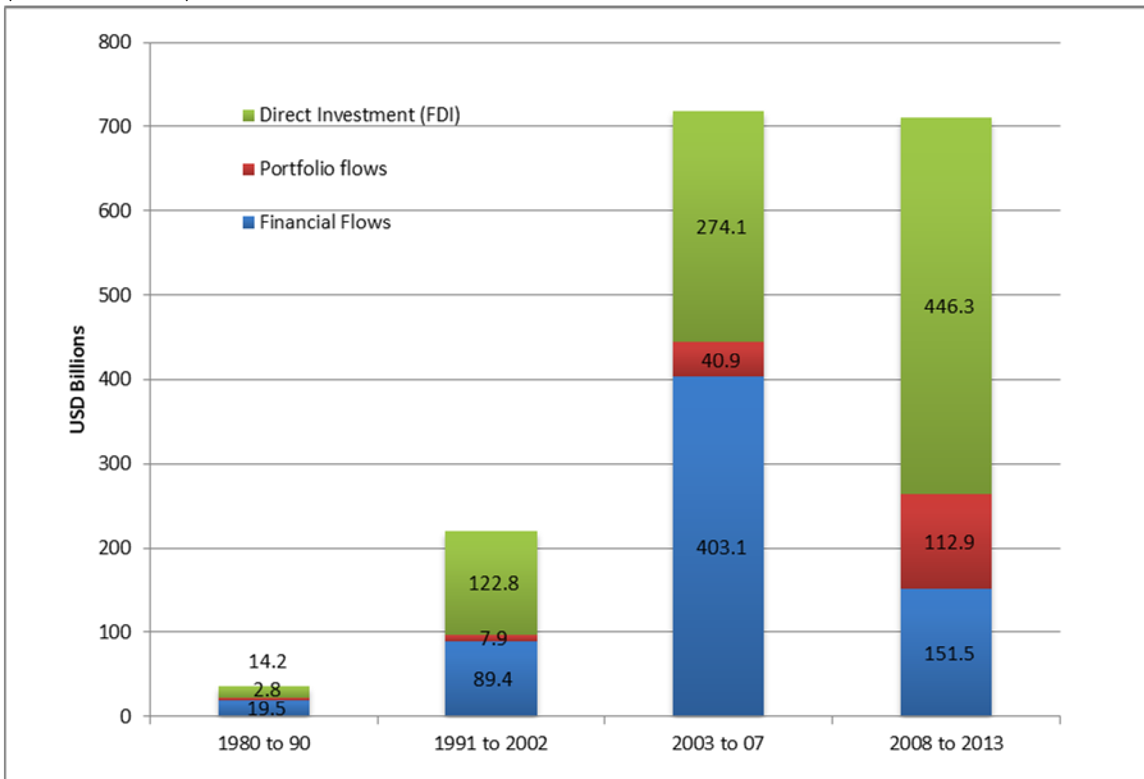
Figure 10: Average annual private capital flows to developing countries by type (1980-2013)



Source: International Monetary Fund, World Economic Outlook Database, April 2014. (Elaborated by author)

Period I: 1980 to 1990

In the first period, from 1980 to 1990, all types of private sector capital flows were limited, with an average total of only $36 billion annually. FDI and bank lending were important in percentage terms, at 53% and 39% of total private sector capital flows respectively, but they were both small in absolute terms. Portfolio flows were much less important, comprising only 8% of the total. All flows were also relatively stable, exhibiting little volatility.

These patterns of flows, and particularly the moderate growth in private sector flows, reflected a number of factors. Banks in advanced economies were suffering repeated losses and had developed risk aversion because of the debt defaults of developing country governments. This issue is discussed further below.

Furthermore, in this period neo-liberal polices relating to the liberalization of markets were largely domestically focused and thus did not impact materially on international trade and capital flows. Hence, nascent financialization was focused on domestic markets rather than international markets.

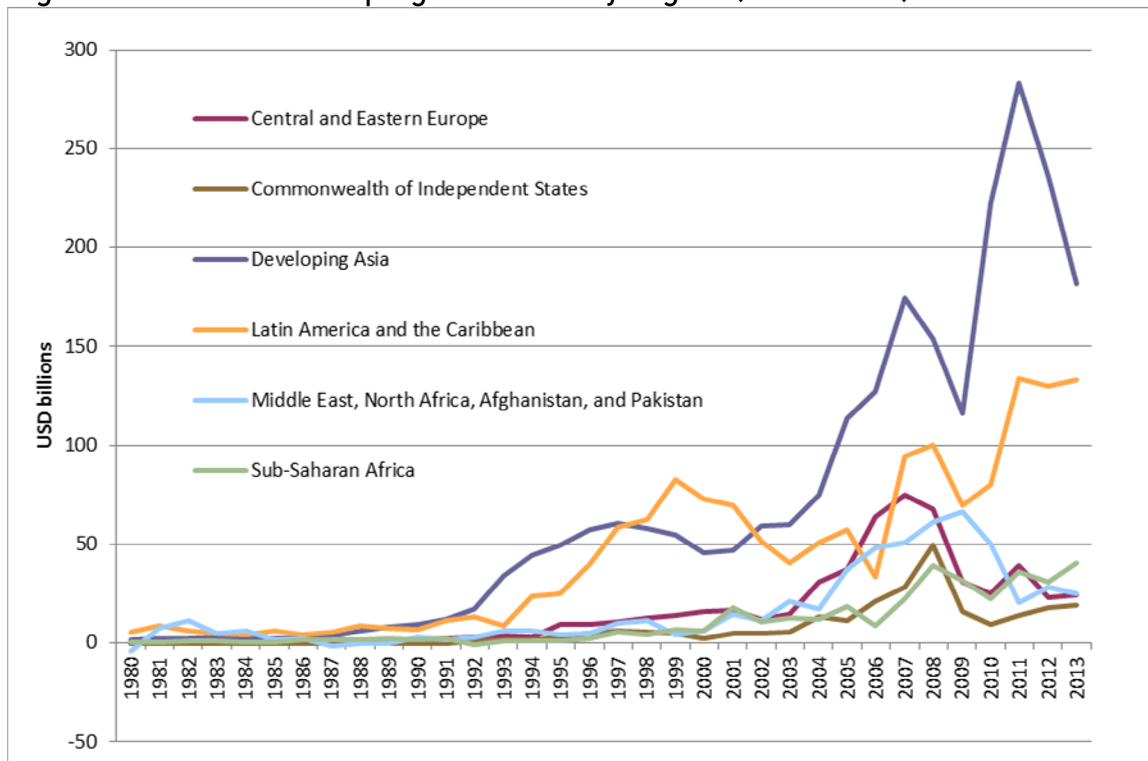
Period II: 1991 to 2002

However, in the second period, from 1991 to 2002, a cyclical upswing in capital flows began, with an annual average flow of $220 billion, more than 4.5 times the average level

in the first period. This upswing was driven primarily by FDI and bank lending. As during the first period, portfolio flows were still low and relatively unimportant.

The increasing flows in FDI caused direct investment to become the most important factor, accounting for 56% of total private sector capital flows. Critically, FDI was also a relatively stable source of capital to developing economies. However, as illustrated in figure 11, the positive trends in FDI were highly concentrated by region. Indeed, in a trend that was to continue through 2013, FDI was largely concentrated in Developing Asia and Latin America. These two regions received 43% and 27% respectively of all global FDI from 1991 to 2013. Such flows were a critical factor in the rapidly expanding economies of this period. For example, China, a major recipient of such flows, achieved GDP growth rates of between 7.8% and 14.2% annually.

Figure 11: FDI to developing countries by region (1980-2013)



Source: International Monetary Fund, World Economic Outlook Database, October 2013. (Elaborated by author)

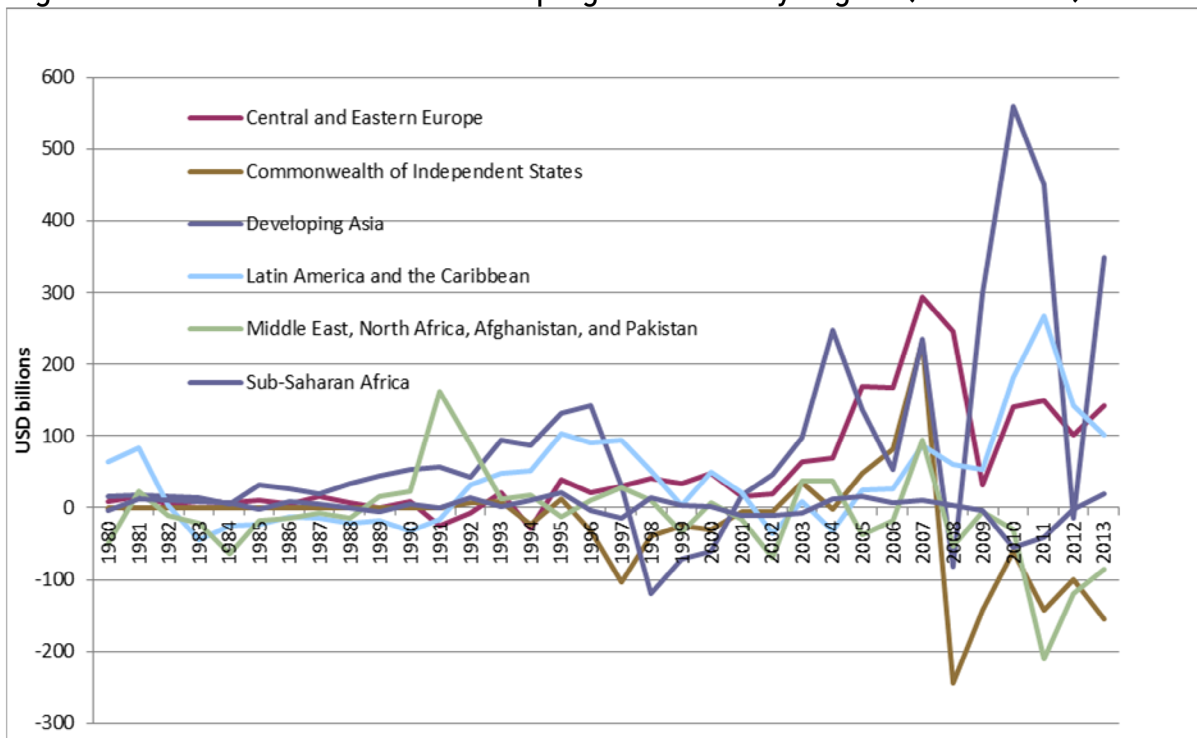
Furthermore, as illustrated in figure 12, bank lending, the main component of financial flows, was also an important component in this period, accounting for 41% of the total. However, it was much more volatile than FDI—first expanding up until 1997 and then rapidly collapsing during the Asian and Latin American crises of 1997 and 1998.

In East Asia, for example, countries hit by the 1997-98 crisis (e.g., Republic of Korea, Indonesia, Malaysia, Thailand and the Philippines) experienced a reversal of more than 10 percent of their combined GDP, mainly through the outflow of commercial bank lending. Such outflows precipitated foreign-exchange and balance-of-payments crises and sharp contractions of GNP (Griffith-Jones, 1998). Similarly, flows to Latin America declined

sharply, including in the late 1990s (Griffith-Jones, 2000) and in the wake of the Argentine default in 2002. These crises in the developing world typically had a common cause: excessive risk-taking and exuberance in financial markets, especially in asset and foreign exchange markets.

By contrast to other regions, sub-Saharan Africa and Central and Eastern Europe did not participate significantly in the "boom-bust" cycles of financial flows in the period of 1991-2002.

Figure 12: Financial flows to developing countries by region (1980-2013)



Source: International Monetary Fund, World Economic Outlook Database, October 2013. (Elaborated by author)

Period III: 2003 to 2007

In the third period, from 2003 to 2007, as financialization peaked in developed countries, there was a further sharp upswing in flows, with FDI growing from $299 billion in 2002 to $889 billion in 2007 and financial flows rising from a negative $30 billion in 2002 to a positive $1.706 trillion in 2007. Indeed, the strength of the FDI flows from the private sector was important for the rapid growth in economies that received such investment, including China and India. Financial flows were also buoyant, as liberalised capital accounts facilitated inflows through bank lending.

Partially driving these trends in this period was an interesting structural shift, the rise of South-South financing. This shift has been notable both in inter-governmental lending and in private sector lending. For example, the UNDP 2013 Human Development Report, "The Rise of the South", regards such trends as important in providing concessional finance, infrastructural investment and technology transfer. The report notes that during 2002-

2012, nearly half of the financing for infrastructure in sub-Saharan Africa was financed by inter-regional governments and regional funds (UNDP, 2013).
China has been particularly active in making financing available to governments in sub-Saharan Africa. China made investment commitments to infrastructure in this region of more than $7 billion in 2006 and more than $4.5 billion in 2007. However, China's financing was highly concentrated, with 30% of its total going to Nigeria and a further 40% to Angola, Ethiopia and Sudan. In these countries, power, water and telecommunications were the largest recipient sectors (Foster et al, 2008).
This kind of trend continued with only a brief pause during the global financial crisis. By 2012, Asia accounted for 31% of global outward FDI, primarily driven by China. Also, financing from within Africa itself had tripled by 2012, primarily driven by financing by South Africa (United Nations, 2013). Similarly, other South-South financing has included financing from the Brazilian government. Sovereign wealth funds, particularly those in the Middle East, are also believed to have been active in such financing. But there has been little transparency with regard to the functioning of such funds (Griffiths Jones and Ocampo, 2008).

Period IV: 2008 to 2013

However, by 2008 the financial crisis spread to developing countries and one of the key channels for transmission from developed to developing countries was private capital flows (although trade and commodity prices were also important factors, which will be discussed below). Because MICS had been the major recipients of private capital flows and many of them had liberalised their financial markets, especially capital accounts, they were the most impacted by these trends. Because LICs had lower levels of connectivity to the international financial system, they experienced more limited effects. The period can be differentiated into the "inter-crisis" period, when the acute effects of the events in 2007 and 2008 continued, and the "post-crisis" period, when the chronic effects of the crisis – and to a lesser extent recovery – were observable.
FDI responded relatively little to the crisis, in contrast to other flows. Inter-crisis FDI attained a level in 2007 of $445 billion, slightly increased in 2008 to $472 billion, and then declined in 2009 to $330 billion, before returning to and then exceeding its pre-crisis level from 2010 to 2013 (Tyson et al, 2014). By 2012, post-crisis FDI inflows to developing countries exceeded inflows to developed countries for the first time (World Investment Report, 2013).
Despite the more limited access of least developed countries to financial flows, there was a positive inflow of FDI to some of them. There were rising levels of FDI, for example, to sub-Saharan Africa (United Nations, 2013; Tyson et al, 2014) although such inflows remained concentrated in commodity-exporting countries (United Nations, 2013). Other important trends for LICs also included a shift in FDI away from commodities and towards infrastructure, manufacturing and services, as well as an increase in debt components relative to equity (United Nations, 2013). Such changes in the levels and composition of FDI flows to sub-Saharan African LICs were generally positive.

However, total bank lending contracted sharply in response to the crisis, falling from a peak of $853 billion in 2007 to an inter-crisis level of a mere $9 billion in 2008. Subsequently, bank lending has been volatile, with peaks and troughs throughout the post-crisis period, including a net outflow in 2012. This pattern reflects the shock of the crisis and subsequent shunning of risk by international banks in advanced economies. This trend was in response to losses due to credit shocks in real estate markets and the Euro-crisis, as well as in response to regulatory reforms that curtailed leverage (Tyson et al, 2014).

While portfolio flows were also growing during the pre-crisis period, they experienced a sharp contraction during the inter-crisis period, before returning to strong, but volatile, post-crisis growth. Expansion of portfolio flows was particularly strong in 2010 and 2011. Though experiencing a sharp contraction in 2012, these flows resumed increasing in 2013. These trends reflected 'push' factors in advanced economies as investors, including those in the shadow banking systems, sought yield opportunities outside of advanced economies, where quantitative easing ("QE") had driven down interest rates and where periodic speculation increased on the assumption of a reversal of such easing, especially in early 2013 (Tyson et al, 2014).

However, these overall trends in cross-border private capital flows also mask important 'pull' factors relating to regional and country-specific trends. In particular, Developing Asia not only received the majority of flows, but also experienced relative stability of flows inter-crisis as well as during the subsequent post-crisis resumption of growth. The post-crisis flows to this region more than doubled the amounts prevailing during the pre-crisis and the inter-crisis periods.

Similarly, Latin America and the Caribbean saw a slight contraction of inter-crisis flows during the acute phase of the global crisis, followed by a strong resumption of growth, with post-crisis flows four times the size of pre-crisis averages. Central and Eastern Europe saw sharp reductions in inter-crisis flows, especially in 2009, before capital flows recovered post-crisis, although only to below pre-crisis levels.

Furthermore, MICs received 98% of all inter-crisis flows and 96% of all post-crisis flows, with three countries - China, Brazil and India – accounting for 26% of all flows during the acute phase of the crisis and 34% during the post-crisis period (Tyson et al, 2014). Hence, cross-border private capital flows have been relatively concentrated.

Several interesting issues emerge from an examination of this period. Firstly, the impact of the global financial crisis was more severe for MICs than for LICs. This is generally agreed to be due to the formers' relative integration into international private capital markets (and trade) (Ocampo et al, 2010; United Nations, 2013). Indeed, by contrast, capital flows to low-income Africa were relatively stable although they were also low (Tyson et al, 2014).

Another important issue was the impact of contagion as a result of developed-country financial instability, not only on flows, but also on financial costs since, during the financial crisis, emerging market debt spreads surged higher (Ocampo et al, 2010). This trend re-occurred in 2013 amid speculation relating to the reversal of quantitative easing and loose monetary policy in advanced countries. This speculation caused rapid deterioration in both

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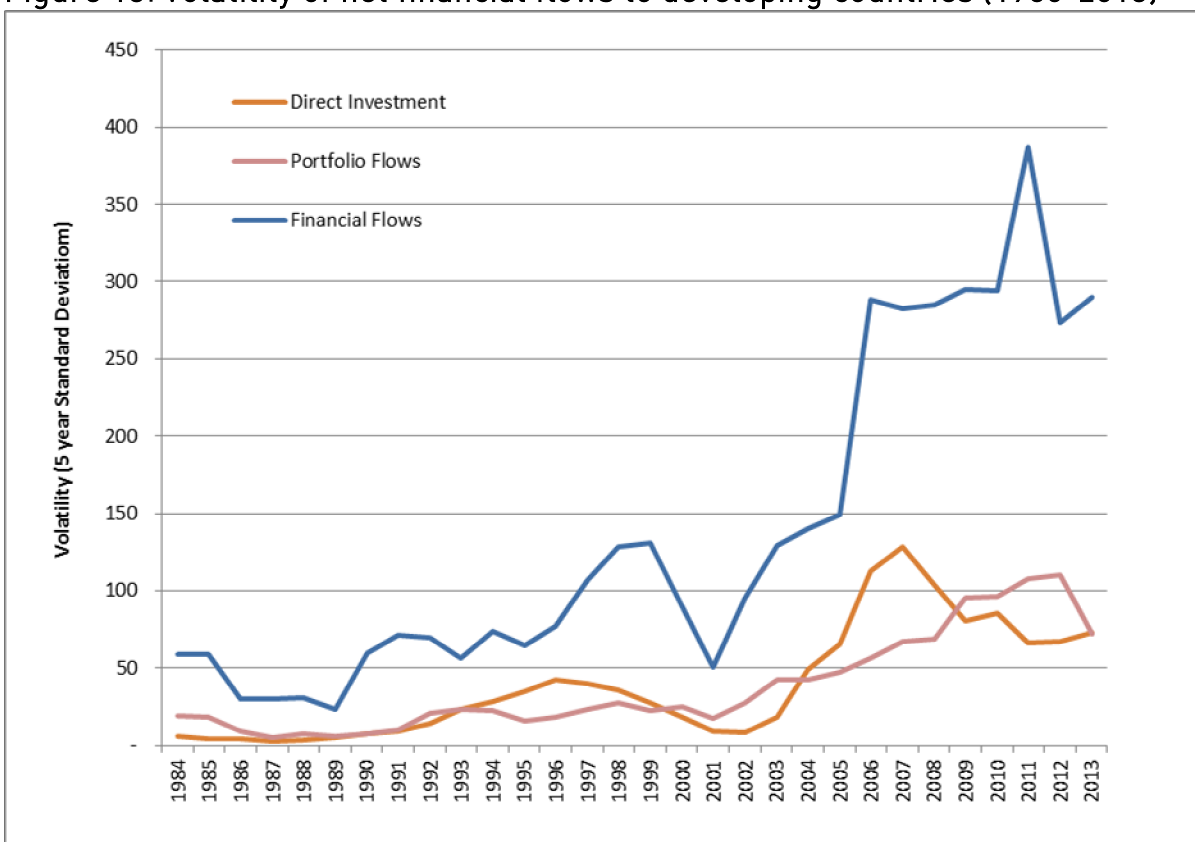
the liquidity and the costs of debt for developing countries (Tyson et al, 2014). Such volatility can cause significant problems for developing countries, especially for government financing, as reliance on private capital flows implies that the cost and the availability of financing cannot be ensured since they are subject to rapidly changing market sentiment (Tyson et al, 2014).

Structural Increases in Volatility

It is important to emphasize that over the long term there has been a trend of increasing volatility in private capital flows. This volatility is illustrated in figure 13 below. Indeed, across the four periods of seemingly differing trends between 1980 and 2013, there has been a continual trend of increasing volatility, especially after 2002. In addition, there has been differentiation among various types of flows. Financial flows have clearly exhibited the greatest volatility. Portfolios flows have also exhibited increasing volatility but to a lesser extent. FDI exhibited increasing volatility until 2007 but then experienced a moderate decline.

Figure 13: Volatility of net financial flows to developing countries (1980-2013)



Source: International Monetary Fund, World Economic Outlook Database, October 2013. (Elaborated by author)

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The Impact of Observed Trends

The most likely causative factor for structural increases in volatility has been the liberalization of financial markets, especially the liberalization of capital accounts. This trend has broadly facilitated increases in capital flows. However, a more careful analysis is needed in order to determine whether the increases in such flows had a positive or negative impact on developing countries.

FDI has been attracted by perceived investment opportunities in developing economies. But FDI inflows have been most robust in rapidly industrializing economies, such as China, as well as in countries where domestic economic growth has encouraged investments in areas such as infrastructure and consumer markets (Ffrench-Davis, 2010). These tendencies could be generally positive since empirical evidence seems to suggest that, by comparison at least to other flows, FDI has the potential to contribute to long-term growth because it is more stable, can complement domestic investment, both in production and through positive spill-over effects, and can have positive impacts through the transfer of technology (Griffith-Jones, 2000).

However, portfolio flows have usually been attracted by short-term opportunities for speculation in equity and bond markets and have been associated with asset bubbles, particularly in real estate and stock markets, and with financial crises in developing countries (Griffith-Jones, 2000). This tendency is explained partially by the fact that the scale of such inflows has often contrasted with the relatively small size of the recipient domestic markets (Griffiths-Jones, 2000).

One of the reasons behind the apparent susceptibility of MICs to financial crises, compared to both LICs and advanced economies, is that they have been undergoing "growing pains" as they have rapidly altered the shape of their economies. At the same time, international institutional investors have exhibited short-term, speculative motives, which have exacerbated the volatility of international capital flows (see, for example, Griffiths-Jones, 2000; BIS, 1998). The likely role of portfolio flows as a contributor to financial crises implies that if those flows reach a very large scale, their long-term net growth and development benefits might, in fact, become negative.

However, during the financial crisis, given the huge scale of the shock occurring in advanced economies, the impact on developing countries was less, in fact, than might have been anticipated. There are two major explanations for this general outcome. Firstly, the strengthening of developing countries' external balance sheets during the boom period that preceded the crisis provided them with a form of macroeconomic "self-insurance". This point is discussed further below.

Secondly, the strong counter-cyclical policy reaction in industrial countries, including expansionary macroeconomic policies and the major recapitalization of financial institutions, led to heightened international liquidity and the rapid search for higher yields across the globe. This trend combined with an increase in risk appetite by investors, based on the belief that many developing countries had better growth prospects than developed ones (Ocampo et al, 2010).

This paper now turns its attention to a broader review of financial and monetary flows to developing countries in order to develop a better understanding of the role and the impact

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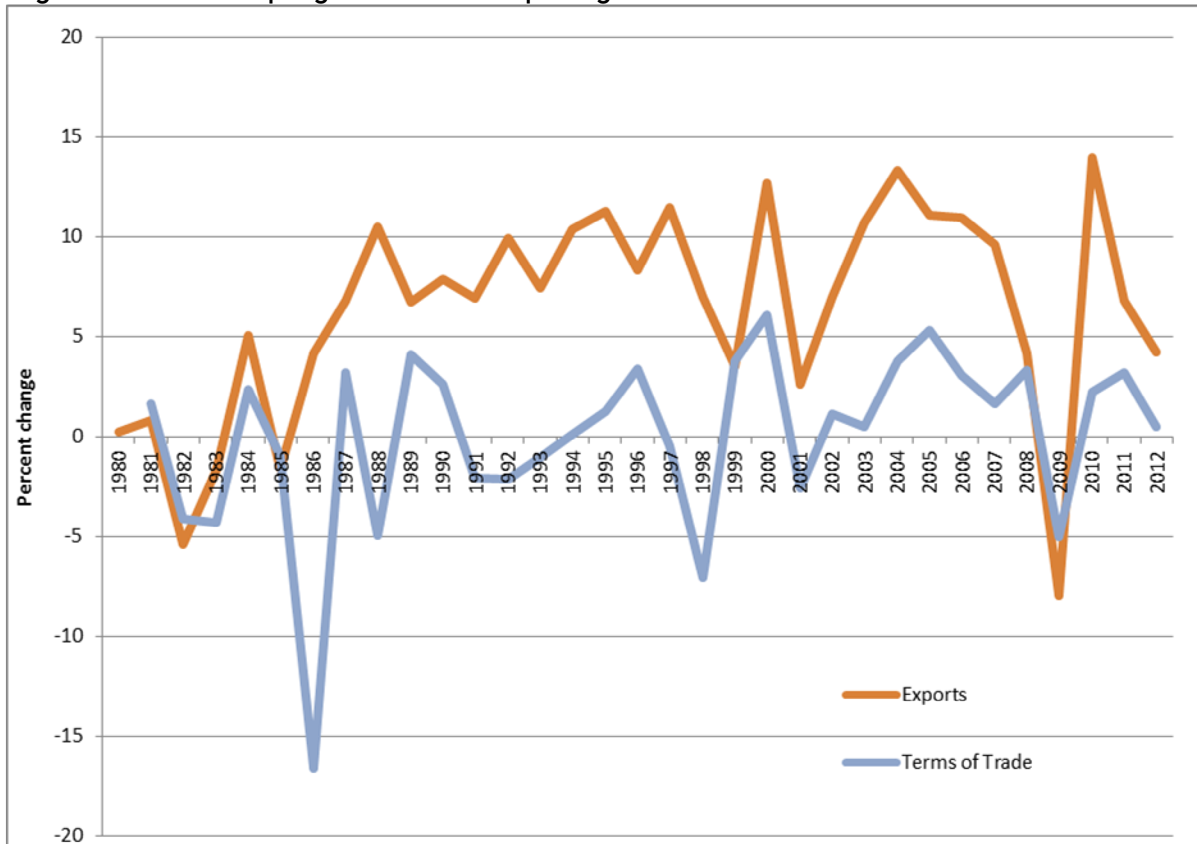
of financialization within this context. It starts with an examination of trade flows and effect on the international reserves of developing economies.

Trends in Trade

From 1980 to 2013, exports from developing countries have consistently expanded, with the exception of a sharp contraction during the global financial crisis. These trends are illustrated in figure 14, which shows that although there have been cycles, growth of trade has been generally positive since the mid-1980s. In addition, world trade has had a tendency to expand more rapidly than world production. Thus, according to UN data, during 2003-2006, for example, world trade volumes grew at an annual rate of 9.3%, more than twice the rate of growth of world output at 3.8% (United Nations, 2009).

This process has been accompanied by a rapid diversification of trade patterns and this trend has been reflected in the nature of the shock transmitted by the global financial crisis. During this crisis, trade volume experienced a sharp contraction, including undergoing a negative growth of -32% between the third quarter of 2008 and the first quarter of 2009. This was a more severe contraction than that experienced during the initial phase of the Great Depression (O'Rourke, 2009). This collapse in trade was driven by sharp contraction in global demand, as well as illiquidity in trade financing.

Figure 14: Developing countries export growth and terms of trade (1980-2012)



Source: International Monetary Fund, World Economic Outlook Database, October 2013.

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Manufacturing trade volumes faced the strongest contraction during this period because there was sharp contraction of demand in developed countries, which were the main importers of manufactures (United Nations, 2010). China suffered from this shock but was able to compensate through macroeconomic policies that expanded domestic demand. However, other countries with a heavy dependence on manufacturing exports but less ability to compensate through domestic policy initiatives were negatively impacted. This included countries in Central and Eastern Europe and in East and South-East Asia, as well as Mexico and Turkey (Ocampo et al, 2010).

This increased volatility resulted from the growth of trade in developing countries, including their rising participation in global value-chains, which increased from 20% of total trade activity in 1990 to 40% by 2012 (United Nations, 2013). Furthermore, developing countries have had more limited capacity to counteract negative effects by exporting their way out of the crisis. This is the strategy that most of them had followed, in fact, during previous, *developing country*-centered crises (Ocampo et al, 2010).

Trade in services has been more resilient than merchandise trade, in part because a sizeable share of services is used in consumption rather than investment. However, there have been exceptions. Some developing countries with substantial participation in service-sector trade, such as Brazil, Indonesia, Mexico and the Republic of Korea, were impacted negatively, as their service-sector export revenues fell. Tourism was also negatively impacted so that countries with important tourism sectors, including Mexico, Central and Eastern Europe and Africa, suffered sizeable negative shocks (World Bank, 2010).

From 2004 to mid-2008, commodity exporting countries had benefited from the most spectacular commodity boom in over a century, both in terms of its duration (five years), intensity and product coverage (World Bank, 2009; UNCTAD, 2009). For example, based on their peak attained during the first semester of 2008, real mineral prices had nearly doubled the average levels that they had attained during the 1970s. However, although commodity prices initially boomed during the crisis, they thereafter experienced a sharp reversal, which had a negative effect on GDP growth (Ocampo et al, 2010). Such commodity price volatility was, arguably, reinforced by the growth in commodities as a tradable asset class, particularly through the growth of derivative trading at financial institutions, including in the shadow banking system.

Agricultural exporters enjoyed a weak positive shock before the global crisis and a neutral effect during it. This development reflects the fact that many agricultural exporters in the developing world have also been energy importers, so that what they had won through increases in the prices of the commodities that they exported was largely nullified by the losses that they experienced through the prices of their energy imports. Regionally, West Asia and the CIS economies experienced the strongest positive and negative shocks, whereas Latin America experienced the weakest. Asia and Africa were in an intermediate position (Ocampo et al, 2010).

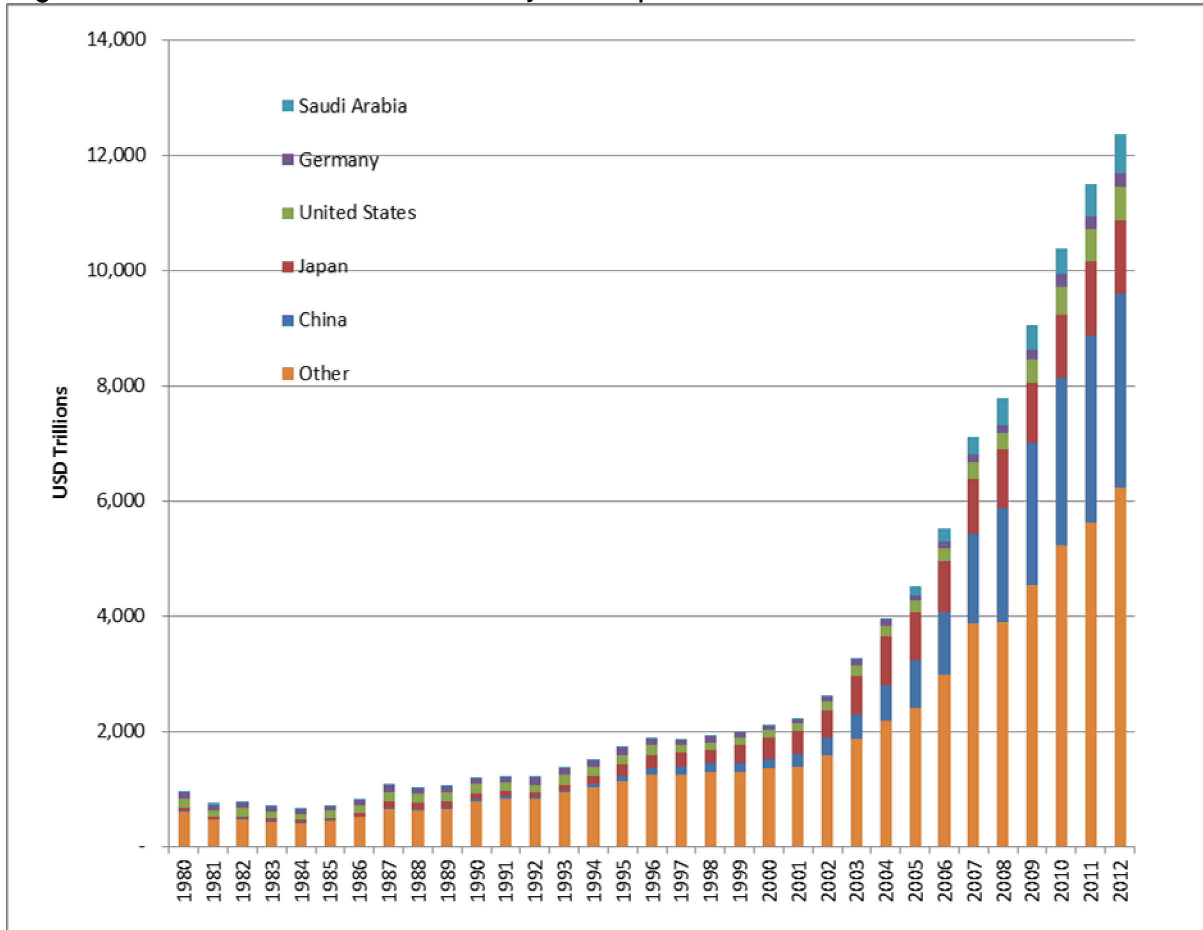
Overall, the contraction of international trade was, arguably, the most important channel of transmission of the world financial crisis to the developing world. The positive shock in trade was equivalent to 3.5% of the developing world's combined GDP before 2008 but this

turned into a negative shock of 4.3% of their GDP in 2009. In other words, there was an overall deterioration of trade equivalent to about 8% of GDP (Ocampo et al, 2010).
Importantly, this trend in trade shocks was likely related to financialization. Firstly, these rates of growth have been highly elastic to world output throughout the business cycle and have, therefore, been more volatile than world production, creating pro-cyclical effects that have interacted and reinforced themselves. This effect has been due not only to the traditional cycles in commodity prices and volumes, but also to pro-cyclical capital flows. Secondly, trade and financial liberalization have been companion policies of the neo-liberal economic agenda and so have been closely related both economically and politically. Thirdly, the financialization of some tradable assets, most notably commodities, has led to increased "herd behavior" in commodity markets and other asset markets, a tendency that has reinforced the price volatility associated with trade cycles.

International Reserves

International reserves have shown a much more consistent pattern during the period of financialization than private capital flows. There has been a steady increase in reserve levels since 1980. Indeed, as illustrated in figure 15 below, between 1980 and 2012, international reserves increased by more than twelve times, from $1 trillion to over $12 trillion. In particular, between 2000 and 2005, emerging market economies accumulated reserves at an annual rate of $250 billion or 3.5% of their annual combined GDP.

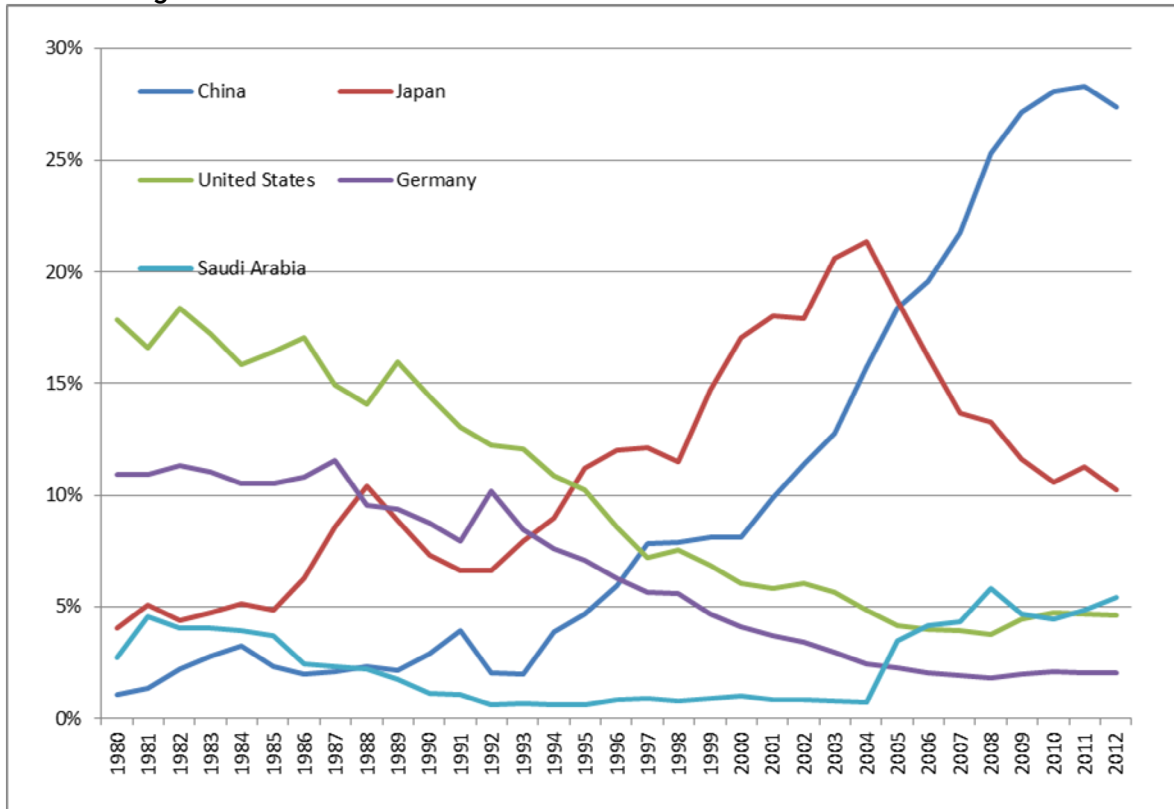
Figure 15: International reserves by the top 5 countries (1980-2012)



Source: World Bank Economic Indicators, October 2013.

However, reserve accumulation was concentrated in a relatively small number of countries, with the top five countries holding more than 50% of total global reserves in 2012 (see both figures 15 and 16). As can be seen, the majority of reserve accumulation was concentrated in Asia and the Middle East. In Asia, this accumulation was due mainly to China, which increased its reserves from originally negligible levels to $3.4 trillion by 2012, accounting thereby for 28% of global reserves. However, other Asian countries exhibited similar trends, including the Republic of Korea, India, Malaysia and Taiwan. In the Middle East, oil export revenues funded large reserve accumulation. In other regions, including Latin America and Central Europe, there was a more modest reserve accumulation, with reserves rising as a percentage of GDP, for example, only in Argentina, the Czech Republic, Mexico and Venezuela between 2000 and 2005 (Mohanty and Turner, 2006).

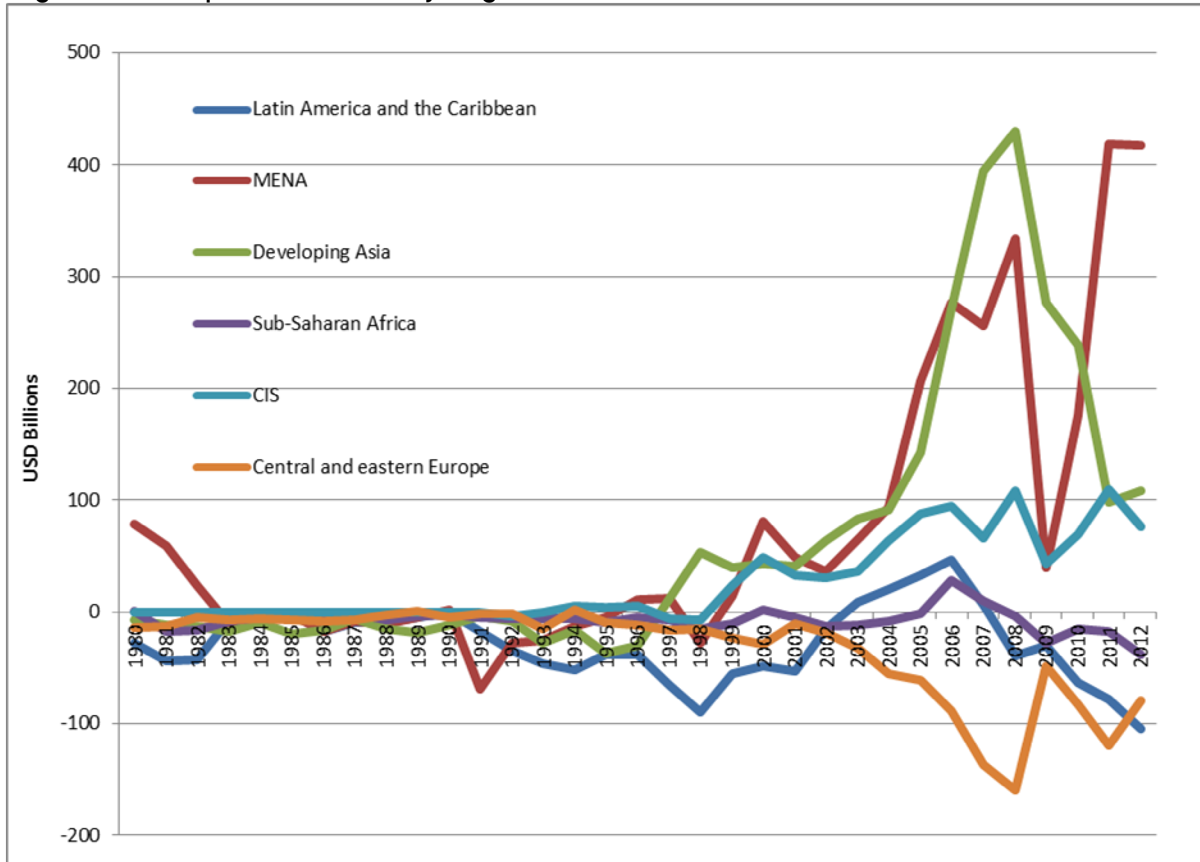
Figure 16: International reserves by the top 5 countries (Percentage of all reserves) (1980-2012)



Source: World Bank Economic Indicators, October 2013.

There were also noteworthy trends in capital accounts in general in developing countries between 1980 and 2012 (see figure 17 below). In the pre-2000 period of accumulation, this tendency was linked to net private capital inflows. However, post-2000, capital-account accumulation was linked mostly to currency reserves, which were accumulated with the specific intention of "self-insurance" against exchange rate pressures. In other words, such reserves were to be used, where necessary, for intervention in currency markets.
There have been, nevertheless, important exceptions. In China, the Republic of Korea and Taiwan, the pressure to appreciate their currencies was driven as much by capital inflows as by current account surpluses. Similarly, net capital inflows have remained much larger than the current account deficit in India and in most of Latin America and Central and Eastern Europe. But a notable exception has been Russia, where current account surpluses have been boosted overwhelmingly by increased oil prices (Mohanty and Turner, 2006).

Figure 17: Capital account by region (1980-2012)



Source: International Monetary Fund, World Economic Outlook Database, October 2013. (Elaborated by author)

Global payments imbalances have been a prominent topic in the debate on the causative factors for the global financial crisis, although there is currently no well-established consensus view. According to one interpretation, Asian and particularly Chinese "mercantilism" generated massive current-account surpluses that increased the demand for US financial assets and kept interest rates, including long-term rates, low. The alternative interpretation emphasizes that the Asian Crisis of 1997 highlighted the lack of an effective mechanism to manage financial crises in developing countries. Hence, these countries have responded by "self-insuring" through accumulating much larger reserves, especially in order to avoid repeating the need for conditional IMF lending.
Regardless of these issues, the persistence of large US current-account deficits in the years leading up to the global crisis made it increasingly clear that the international monetary system had not imposed any discipline on the country that enjoys the 'exorbitant privilege' of issuing the world's dominant reserve currency. This problem is widely known as the "Triffin Dilemma". The resultant problem is that the ability of the US to run large current account deficits has tended to intensify financial instability (Ocampo et al, 2010).

External Debt

During the 1970s there was an accumulation of external debt in many developing countries as surplus capital accumulated by oil-producers was re-circulated by advanced-

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country banking systems into the "third world". But by the early 1980s, and following surges in interest rates as advanced economies tightened monetary policy in order to tackle inflation and foreign exchange volatility, developing countries were unable to repay their debt and there were widespread defaults, especially in Africa and Latin America.

In Africa, the external debt burden increased significantly between 1970 and 1999—for example, from just over $11 billion in 1970 to over $120 billion by the early 1980s. Between 1980 and 1994, the average debt to GDP ratio of Africa rose from 38 per cent to 70 per cent (UNCTAD, 2004). The IMF and other International Financial Institutions (IFIs) required a comprehensive program of structural adjustment as a condition to extend financing and this policy resulted in further increases in debt to a peak of about $340 billion in 1995, the year immediately preceding the launch of the original Heavily Indebted Poor Country Initiative (HIPC). Over the period of 1970-1999, total debt service paid by the continent increased from about $3.5 billion to a peak of $26 billion, a trend that further added to its debt arrears.

Similarly in Latin America, there was large-scale borrowing from US commercial banks and other creditors during the 1970s. In 1970, total outstanding debt from all sources totalled only $29 billion. But, by 1982, the debt level had reached $327 billion. This latter level proved to be unsustainable as interest rates rose and liquidity contracted in the early 1980s. In June 1982 Mexico defaulted, followed by 16 other Latin American countries that sought to reschedule their debts (Source: Federal Reserve History Archives).

As advanced-economy banks contracted credit in the face of such defaults, both Latin America and Africa experienced a sharp reduction in GDP and a subsequent collapse of living standards, entering a "Lost Decade" of economic development.

There were a number of debt relief and debt-workout initiatives, including from the Paris Club, which addressed the debt of MICs. In 1996, the IMF and the World Bank created the Heavily Indebted Poor Countries ("HIPC") Initiative to assist LICs with unsustainable external public debt burdens. The goal of the HIPC Initiative was to reduce the external public debt burden of all "eligible" countries to sustainable levels in a reasonably short period of time. Since then, initiatives to reduce external debt have continued, although they have been criticised as inadequate by some commentators (UNCTAD, 2004), and some small and fragile states, such as those in the Caribbean, still continue to have excessive debt burdens (United Nations, 2013).

In 2005, in order to help accelerate progress toward the United Nations Millennium Development Goals (MDGs), the HIPC Initiative was supplemented by the Multilateral Debt Relief Initiative (MDRI). As a result, debt relief was agreed for many LICs by 2010. The MDRI allows for 100 percent relief on eligible debts by three institutions—the IMF, the World Bank, and the African Development Bank (AfDB)—for countries completing the HIPC Initiative process. In 2007, the Inter-American Development Bank (IADB) also decided to provide additional ("beyond HIPC") debt relief to the five HIPCs in the Western Hemisphere (UNCTAD, 2009). Such initiatives have contributed significantly to reductions in external debt burdens, particularly for LICs, and especially in sub-Saharan Africa.

By the early 2000s, two new trends in external debt could be observed. Firstly, as a percentage of GDP, debt levels had been significantly reduced for many developing

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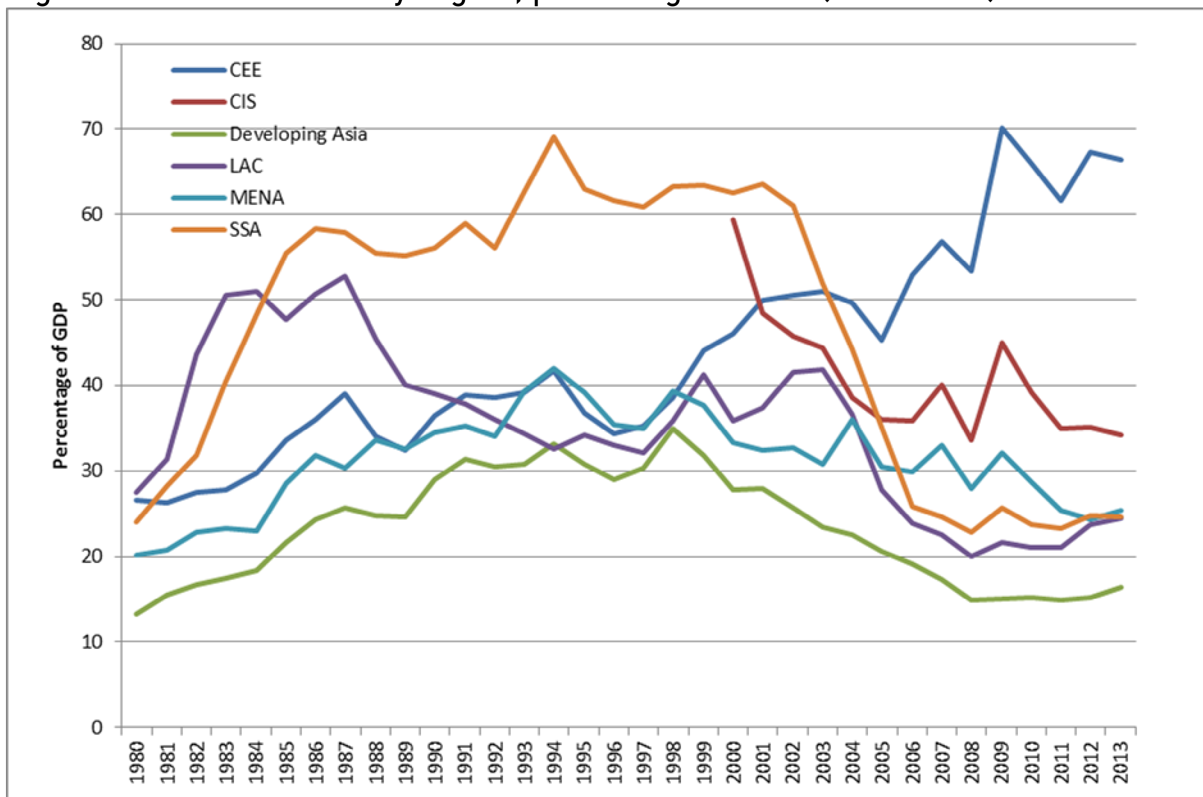
countries and appeared to be more sustainable as a result. For example, in sub-Saharan Africa debt had been reduced, on average, from a peak of 69% of GDP in 1994 to 24% by 2012. This trend is illustrated in figure 18 below.

Secondly, however, debt levels on an absolute basis had increased, as illustrated in figure 19. But since this trend was strongest amongst the faster growing and richer regions – for example, in Developing Asia – the GDP ratio remained subdued and thus more sustainable. Indeed, overall, debt levels appear to be more sustainable than in the past, as measured by stability in both the ratio of external debt service to GNI and the ratio of external debt service to export earnings since 2000.

Regarding the latter, between 2000 and 2010, despite a 12 percent increase in developing countries' external debt obligations in absolute terms, the average ratio of debt service to export earnings had fallen for all middle-income countries from 21% to 10%. In LICs there were also improvements, with the average debt service to export ratio falling from 17.2% to 4.8% during the same period. This trend was partially attributable to debt relief programs but also to increased exported earnings (World Bank, 2012).

Figure 18: External debt by region, percentage of GDP (1980-2013)



Source: International Monetary Fund, World Economic Outlook Database, October 2013.

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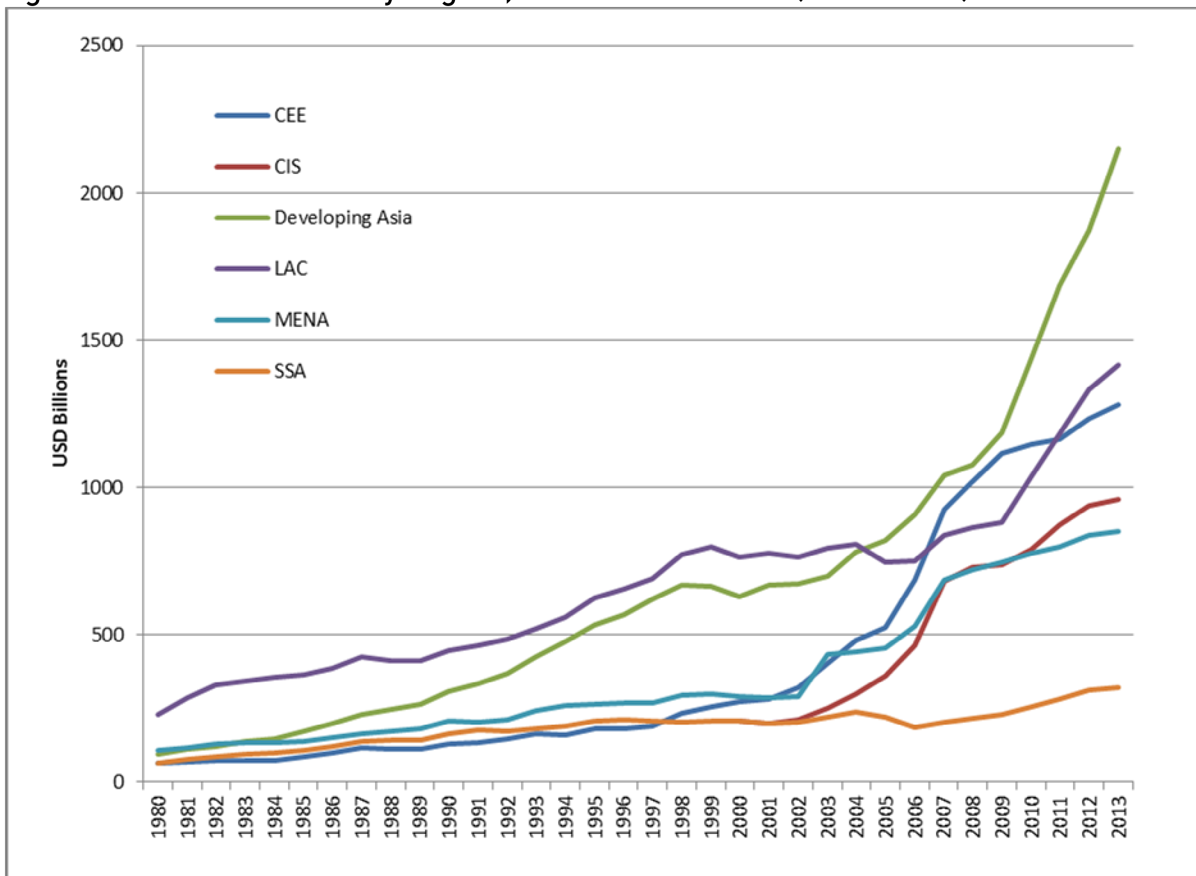
Figure 19: External debt by region, in absolute terms (1980-2013)



Source: International Monetary Fund, World Economic Outlook Database, October 2013.

However, there were also important structural shifts in external debt, particularly in the post-crisis period. Firstly, there was a shift from public to private debt. Indeed, in 2000 developing-country public-sector debt was 63% of all debt (or USD 1.3 trillion) compared to 27% accounted for by private-sector debt (USD 0.5 trillion). But by 2011 this relationship had shifted to a 50%:50% ratio ($1.7 trillion each) (Source: World Bank's 2013 International Development Statistics).

This result is partially due to the fact that some developing countries, including LICs, had been able to access capital markets for bond issuances and reduce their reliance on constrained bank lending. However, this type of financing has increased their reliance on investor portfolio financing and on instruments for which maturities are typically shorter and costs higher than for the concessional financing that had been thereby replaced (World Bank, 2012; United Nations, 2013; Tyson et al, 2014).

Remittances

Remittances are defined as compensation of employees plus "personal transfers". They comprise "all current transfers in cash or in kind made or received by resident households to or from non-resident households" (Source: IMF, 2009).

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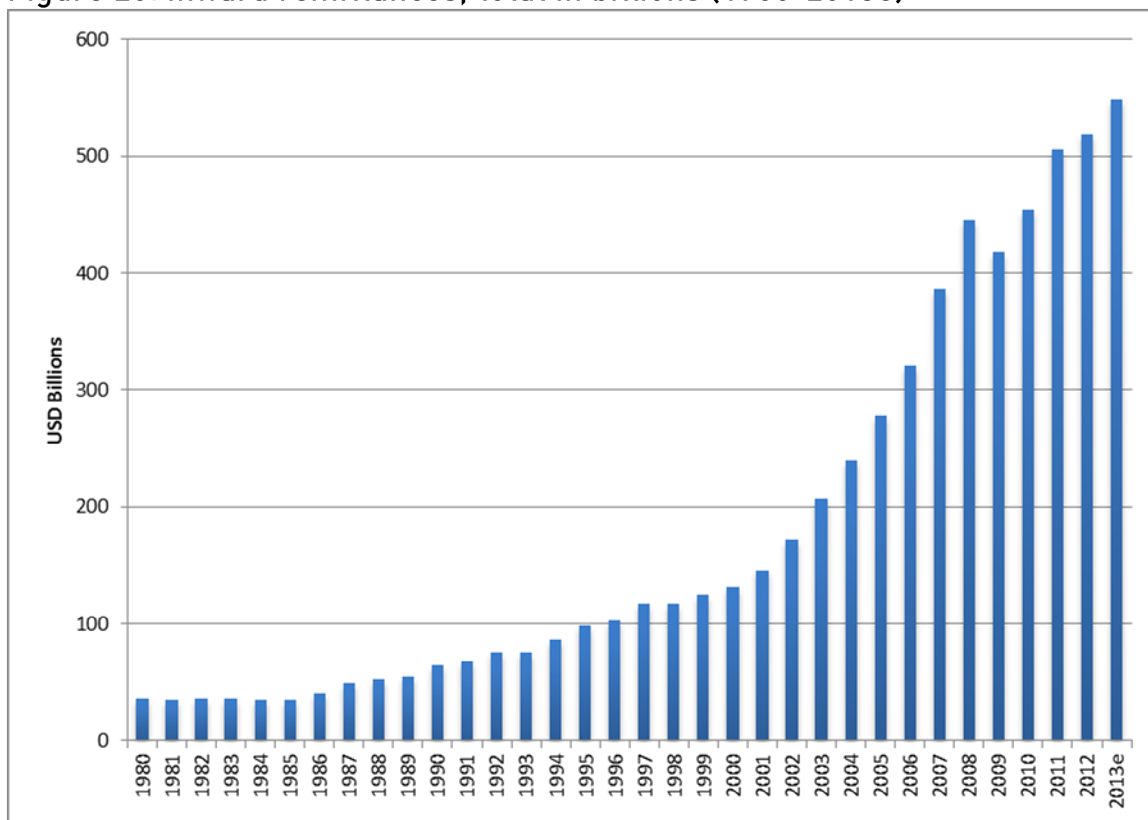
In contrast to the volatility of private capital flows, remittances have shown, overall, a strong and fairly consistent growth trend in the period of financialization (except for 2009). As illustrated in figure 20 below, remittances to developing countries grew from negligible levels in 1980 to reach $518 billion by 2013. Indeed, by 2012, remittances were nearly three times the level of ODA and larger than private debt and portfolio equity flows. In addition, they exceeded the foreign exchange reserves in at least 14 developing countries, and were equivalent to at least half of the level of reserves in more than 26 developing countries (World Bank, 2013). Hence, they have come to represent a significant source of monetary inflows for developing countries.

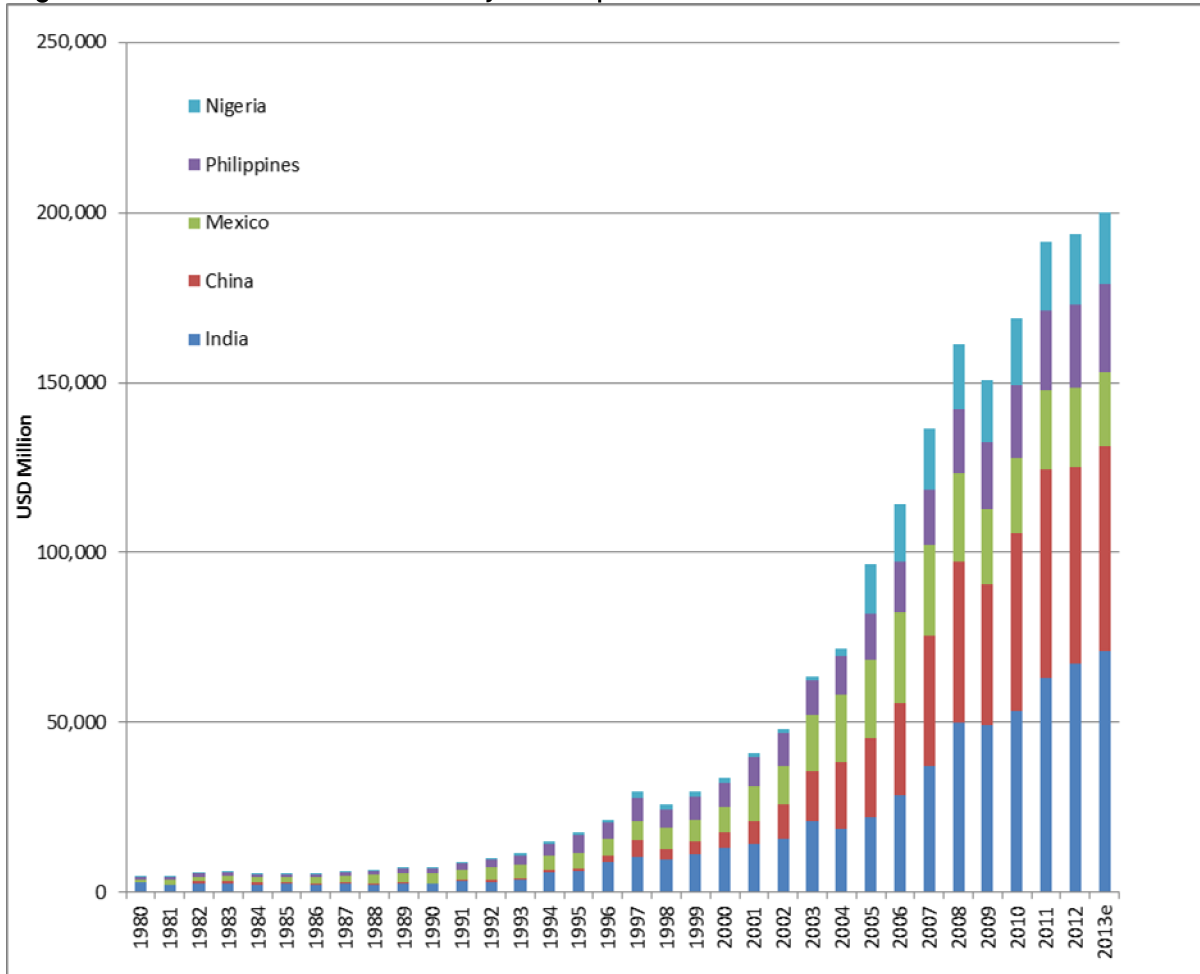
Figure 20: Inward remittances, total in billions (1980-2013e)



Source: World Bank staff calculation based on data from IMF Balance of Payments Statistics database and data releases from central banks, national statistical agencies and World Bank country desks (www.worldbank.org/migration October, 2013).

This trend is especially relevant for certain countries in which remittances are concentrated in both relative and absolute terms, including for a number of small states. In absolute terms, the top recipients of remittances by 2013 were India ($71 billion), China ($60 billion), the Philippines ($26 billion), Mexico ($22 billion) and Nigeria ($21 billion) (see figure 21 below). These five countries accounted for approximately 40% of all such global flows. Other large recipients (in absolute terms) included Egypt, Pakistan, Bangladesh, Vietnam and the Ukraine (World Bank, 2013).

Figure 21: Inward remittances by the top 5 countries (1980-2013e)



Source: World Bank staff calculation based on data from IMF Balance of Payments Statistics database and data releases from central banks, national statistical agencies and World Bank country desks (www.worldbank.org/migration October, 2013).

However, as already noted, remittances can also be of particular importance to smaller states and fragile states. Table 1 below gives details of 2012 remittances as a percentage of GDP. The top recipients of remittances relative to GDP included low-income countries such as Tajikistan (48.1 percent), Kyrgyz Republic (31.4 percent), Nepal (24.7 percent), Haiti (20.6 percent) and Liberia (20.4 percent). Top recipients also included fragile states or states where there has been a recent history of conflict, such as Lebanon, Kosovo, Bosnia and Herzegovina, Egypt and Sri Lanka (World Bank, 2013

Table 1: Remittances as a percentage of GDP in 2012 (Over 5%)

Country	% of GDP
Tajikistan	48.1%
Kyrgyz Republic	31.4%
Nepal	24.7%
Lesotho	24.6%
Moldova	24.5%
Armenia	21.4%
Haiti	20.6%
Samoa	20.6%
Liberia	20.4%
Lebanon	17.0%
Kosovo	17.0%
Guyana	16.5%
El Salvador	16.5%
Honduras	15.7%
Gambia, The	15.4%
Jamaica	14.5%
Bangladesh	12.2%
Jordan	11.4%
Georgia	11.1%
Bosnia and Herzegovina	10.8%
Senegal	10.4%
Timor-Leste	10.1%
Sri Lanka	10.1%
Guatemala	10.0%
Philippines	9.8%
Nicaragua	9.7%
Togo	8.8%
Cape Verde	8.8%
Montenegro	7.9%
Nigeria	7.9%
Albania	7.8%
Egypt, Arab Rep.	7.5%
Serbia	7.4%
Vietnam	7.1%
Morocco	6.8%
Dominican Republic	6.1%
Pakistan	6.1%
St. Kitts and Nevis	6.0%
Guinea-Bissau	5.1%
Tunisia	5.0%

Source: World Bank staff calculation based on data from IMF Balance of Payments Statistics database and data releases from central banks, national statistical agencies and World Bank country desks (www.worldbank.org/migration October, 2013).

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These remittance patterns reflect labour migration patterns and diaspora trends, including a mix of skilled and unskilled labour migrants. For example, Mexico has had high levels of out-migration, with an estimated 12 million Mexican-born residents in the United States in 2012 (Source: US Census, 2012). Similarly, the Philippines has had high levels of labour migration to destinations such as the US, Canada, Saudi Arabia, the UK and Japan. Nigeria has been by far the largest recipient of remittance inflows in sub-Saharan Africa, accounting for about 67 percent of all such inflows to the region in 2012. About half of remittance flows to the country in 2011 originated from the US and the UK, with another 40 percent coming from Chad, Italy, Cameroon, Spain, Germany, Ireland and Benin. In addition to having large numbers of unskilled migrants working mainly in the Middle East, India also has had a large skilled diaspora that remit funds from the United States and Europe (World Bank, 2013).

However, during the recent financial crisis, there was a significant shock inflicted on such countries from the drop in remittance flows. Such a trend was pronounced in Latin America and the Caribbean, Eastern Europe and Central Asia, and among some countries in North Africa (Ocampo et al, 2010).

Latin America and the Caribbean was the region that was affected the earliest, with its remittances growing only very slowly both in 2007 and 2008 and falling as a proportion of GDP in both years, in sharp contrast with their rapid growth earlier in the decade. These trends reflected the importance of the employment of migrant workers in the US and Spanish construction sectors, which contracted sharply following the collapse of their housing markets from 2007 onwards (Ocampo et al, 2010).

Eastern Europe and Central Asia also experienced a strong negative shock to remittances in 2009, with an overall reduction of close to 15% in such flows. Former Soviet Republics in Eastern Europe and Central Asia had been heavily dependent on remittances from migrants living in Russia. Also, many migrants from Poland and Romania worked in the United Kingdom and thus their remittances in 2009 fell by 21% and 15% respectively (Ocampo et al, 2010).

Although remittances to North Africa and the Middle East fell by less, the large average share of remittances in the income of these economies meant that this region was also significantly affected. Because Morocco and Egypt, the principal recipients in the region, depended on migration to Europe, mainly to France and Spain, they experienced the sharpest contractions (20% for both in the first half of 2009) (Ocampo et al, 2010).

There were also a number of small or fragile states that were heavily impacted by this remittance shock. For example, Tajikistan experienced a drop in remittances equivalent to 14.2% of its GDP, Moldova experienced a fall equivalent to 6.7% of its GDP and Kyrgyz Republic a fall corresponding to 5.0%. There were an additional 11 countries that suffered impacts equivalent to between 1% and 5% of their GDPs in 2009 (Ocampo et al, 2009). Such figures illustrate not only the important financing role of remittances globally, but also their key importance to small and fragile states (Ocampo et al, 2010).

However, remittance flows to South Asia, a region with heavy dependence on this source of income, were less impacted by the financial crisis. In this region there was still growth in remittances in 2008 and only a small fall in 2009. The reason was that their migrant

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employment in Gulf countries was relatively stable. In fact, remittances actually increased in 2009 from the Middle East to Pakistan, Bangladesh and Nepal as well as to the Philippines. Similarly, transfers to sub-Saharan Africa, which had come in large measure from other countries in Africa and the Middle East, proved fairly resilient during the global crisis (Ocampo et al, 2010)

Differences in exchange rates were an important factor in explaining some of the differences in the flows of remittances during and after the crisis. For example, Ecuador, a dollarized economy with heavy migration to Spain, experienced first an adverse effect and then a positive effect from the variations of the euro/dollar exchange rate. Polish and Romanian migrants to the United Kingdom were negatively affected by the depreciation of the British pound.

Since several recipient countries experienced a depreciation of their own currencies, this factor operated in a favorable way, compensating for the reduction of remittances in dollar terms. For example, in Mexico and Colombia, the two largest recipients of remittances in Latin America in absolute terms, domestic recipients actually saw an increase in the domestic purchasing power of remittance flows thanks to the depreciation of their pesos (Ocampo et al, 2010).

The impact of remittances at both a macro- and micro-economic level remains under-researched. However, current research suggests that, at the macro-economic level, remittances have had generally favourable impacts. For example, remittances can be countercyclical and stabilizing. Remittances rose during the financial crises in Mexico in 1995 and in Indonesia and Thailand in 1998. Remittances also tend to increase following natural disasters and political conflicts. In sub-Saharan Africa, remittances have been more stable, in fact, than both FDI and private debt and equity flows.

International Aid

Despite being dwarfed by private capital flows, official development assistance remains an important source of financing, particularly for low-income countries and fragile states. It can assume a number of forms, from outright grants to subsidised financing and technical assistance. The biggest donors of aid are the United States, Japan and the European Union (followed by the majority of other developed countries) either through multilateral organizations or through bilateral arrangements.

ODA in absolute terms was relatively stable between 1990 and 2000, although it fell between 1993 and 1997 due to fiscal consolidation in donor countries after the recession of the early 1990s. Aid started to rise in real terms in 1998, but was still at its historic low as a share of GNI (0.22%) in 2001. It then grew sharply from 2002 onwards, before stabilizing in the post-2007 period because of political commitments that had been made in Monterey in 2002 and commitments by the European Union and the G8 in 2005 (Te Velde and Massa, 2009). In 2011, ODA reached its highest real level ever at USD 134 billion. ODA also increased as a percentage of donors' GNI to 0.29% by 2012 despite a decline from its 2010 peak to a level of USD 125.9 billion. This decline reflected post-crisis fiscal contraction in donor countries (United Nations, 2013).

These trends are illustrated in figures 22 and 23 below.

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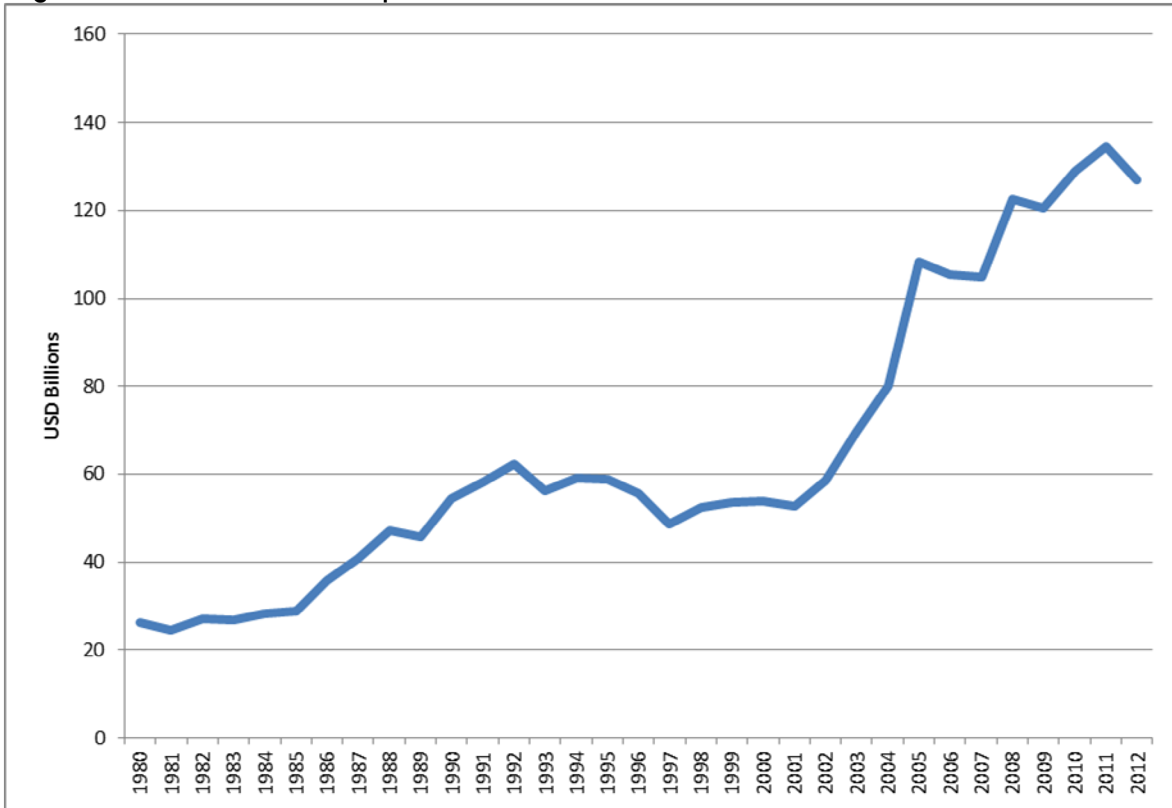
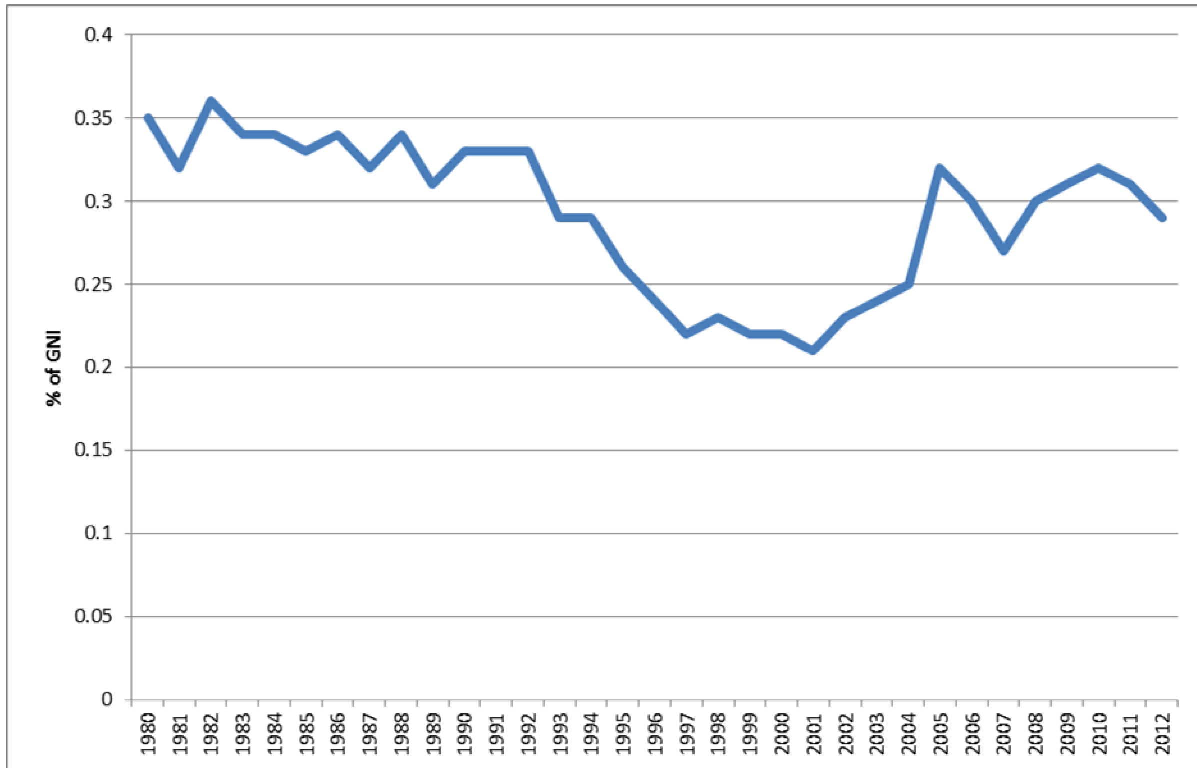
Figure 22: Official Development Assistance in absolute terms (1980 to 2012)



Source: OECD "Datalab". Key Indicators/ODA December 2013 (http://www.oecd.org/statistics/)

Figure 23: Official Development Assistance as percentage of donor GNI (1980 to 2012)



Source: OECD "Datalab". Key Indicators/ODA December 2013 (http://www.oecd.org/statistics/)

The recipients of ODA have been concentrated in lower MICs and LICs. In 2012, the top 10 recipients received 26% of all ODA. They included Afghanistan ($5.8 billion), the Democratic Republic of Congo ($3.9 billion), India ($3.0 billion), Vietnam ($2.8 billion), Pakistan ($2.2 billion), Indonesia ($2.1 billion), China ($2.1 billion) (which graduated to Upper MIC status in 2010), Ethiopia ($1.9 billion), Kenya ($1.8 billion) and Tanzania ($1.7 billion). ODA flows peaked in 2005 and 2006 due to exceptional debt relief operations for Iraq and Nigeria and a sizable increase in ODA to Afghanistan (Source: OECD "Datalab". Key Indicators/ODA December 2013 (http://www.oecd.org/statistics/).

Global ODA is expected to stagnate in the 2014 to 2016 period, with only MICs expected to increase their aid to other countries (United Nations, 2013). Importantly, ODA is increasingly becoming a South-South flow. By 2010, South-South ODA was estimated to have reached between $12.9 billion and $14.8 billion (United Nations, 2013). Important non-G7 donors included new emerging economies, such as Brazil, China, India and South Africa, although their aid remained significantly smaller than that of OECD donors (ODI, 2014). Indeed, total BRIC loan commitments amounted to about US$26 billion during 2000-2008 compared to about US$296 billion from the OECD. Thus the BRIC ODA represented only 3% of total concessional lending.

Countries that have received the largest loan financing from BRICs have included Angola, Bhutan and Tajikistan. China, the most important MIC donor, tends to provide a small amount of loan financing to a broad range of LICs (Mwase, 2011). However, the majority of South-South ODA has assumed the form of bilateral programs for project funding and has

often been integrated into commercial transactions involving trade, investment and loans (United Nations, 2013). Thus, it remains to be seen how South-South ODA could differ from the character of North-South ODA and whether it will become an important source of development financing in the future.

Summary of Trends

The period of financialization from 1980 to 2013 was characterized by major changes in developing economies. Accompanying their growth in GDP was growth in their domestic financial markets and their increased receipt of international capital flows. During 2000-2007, in particular, developing economies grew rapidly. But financialization of their economies also intensified. While FDI increased significantly during 2000-2007, boosting the prospects for increased investment, speculative flows of capital also expanded, causing more widespread instability. As a result, the bulk of research on financial flows has not identified a clear positive relationship between financialization, on the one hand, and enhanced economic growth and development, on the other.

Cross-border private capital flows are comprised of three major components: 1) Foreign Direct Investment (FDI), 2) Portfolio Flows, which comprise equity and bond flows of various types, and 3) Financial Flows, which are primarily net bank lending. The latter two flows are more short-term in nature than FDI and also more unstable.

This research paper has reviewed the patterns of these three kinds of private capital flows over four distinct periods: 1980-1990, 1991-2002, 2003-2007 and 2008-2013. In the first period private capital flows were fairly limited. But in the second, 1991-2002, they experienced a cyclical upswing. FDI increased, but so did international bank lending. The latter type of capital flow was decidedly more unstable and helped trigger various financial crises in developing economies, especially in East Asia and Latin America. These crises were particularly damaging because they triggered sharp recessions and prolonged slumps in growth.

During the third period, 2003-2007, there was a sharp upswing in cross-border private capital flows, which coincided with the increased growth of GDP and the moderation of inflationary pressures in developing economies. The forces of financialization peaked during this period, culminating in a global financial crisis in 2008, which was centred in developed economies.

The fourth period, 2008-2013, includes both an 'inter-crisis' and a 'post-crisis' period. During this whole period both international bank lending and portfolio flows contracted sharply. However, some regions, such as Developing Asia, experienced more stability than others. In general, though, Middle-Income Countries (MICs) faced the greatest problems since private capital flows had been concentrated in this income grouping during the period leading up to the global crisis. More recently, as central banks in the developed economies have begun to withdraw from policies of quantitative easing (such as during 2013), MICs have been particularly hard-hit by large precipitous capital outflows.

Despite experiencing distinctive patterns over the four periods from 1980 to 2013, cross-border private capital flows have exhibited a general tendency of increasing volatility, particularly volatility of both portfolio flows and financial flows. This tendency has coincided with the general long-term trend of increasing liberalization of financial markets. As a result, speculative capital flows, which concentrate on short-term opportunities for profit maximization, have increased in importance, culminating in some cases in destabilizing 'asset bubbles', particularly in stock and real-estate markets.

During the whole period 1980-2013 international trade also expanded rapidly. In fact, world trade expanded more rapidly than world production. But trade contracted very sharply during the global financial crisis beginning in 2008, driven mainly by plummeting global demand. But financial factors were also at work since there was a concomitant collapse in trade financing. Moreover, the on-going financialization of tradable assets, particularly commodities, had led to greater financial and economic instability.

The most pronounced collapse in trade was in manufacturing, although services and agriculture also suffered setbacks. Arguably, the contraction of international trade had a more pronounced impact on developing economies (particularly Lower Middle-Income Countries and Low-Income Countries) than the crisis in financial flows.

In addition, because the financial crisis was centred in developed economies, most developing economies had very limited ability to counteract its effects. Some of the major emerging economies, such as the Peoples Republic of China, used domestic counter-cyclical macroeconomic policies in order to counteract the negative effects of the global financial crisis and the concomitant collapse in its export trade. But most other developing economies did not possess adequate fiscal means to implement similar policies.

Many developing economies had managed to develop some degree of protection against instabilities in capital flows by building up their international reserves, particularly since the Asia financial crisis of 1997-1998. In fact, at the global level international reserves had increased in absolute terms by a factor of about 12 between 1980 and 2012. Despite some setbacks after 2008, three regions (Developing Asia, MENA and the CIS) continued to account for a substantial proportion of all reserves in developing economies.

After 2000, many of the increases in the capital accounts of developing economies were due to the accumulation of international reserves. Such an accumulation was regarded as an important form of self-insurance against trade and financial instability and a means of enhancing policy independence. In some major developing economies, such as China and the Republic of Korea, capital inflows outweighed the importance of the accumulation of reserves, though these were exceptions to the general trend.

Nevertheless, the ability of the United States to run large current-account deficits, because it issues the world's dominant reserve currency (and thus is guaranteed to receive continuously large capital inflows), imparts a worrying degree of instability to the international monetary system. This condition thus tends to magnify financial instability at the global level.

Thankfully, the external debt burdens of many developing economies have been significantly reduced since the mid 1990s. The HIPC Initiative for Low-Income Countries was initiated in 1996 and was supplemented by the Multilateral Debt Relief Initiative

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beginning in 2005. Hence, external debt as a ratio to GDP began to fall appreciably, especially in sub-Saharan Africa. At the same time, debt in absolute terms continued to rise. But since GDP and export earnings were also generally rising, this trend did not counteract the overall fall in the debt ratio or in the debt servicing ratio of developing economies.

However, it is important to note that there have been some important structural changes in external debt. One is that bilateral financing, especially from MICs, has been on the rise vis-à-vis multilateral financing. China is now an important bilateral lender, for example. Another important structural change has been the displacement of debt owed to public lenders by debt owed to private lenders. This trend could portend serious problems for developing economies since the privately issued debt that they have been incurring is of a more short-term nature and it is more costly to service than concessional loans.

Though the current magnitude of ODA has been dwarfed by private capital flows, it still remains an important source of development financing, primarily for Low-Income Countries and fragile states. Despite the global financial crisis and constraints on the budgets of donor countries, ODA in 2011 reached, in fact, its highest level in real absolute terms. Despite a dip as a result of the crisis, ODA relative to donor GNI remained at a relatively high historical level in 2012, i.e., around 3%.

However, in the coming period ODA is expected to stagnate, even though Middle-Income Countries are likely to increase their share of the global total. In fact, an important factor that merits emphasis has been the recent rise in South-South development assistance, such as that provided by China, Brazil, India and South Africa. Though still small as a percentage of total global ODA, such assistance is likely to increase in importance in the future.

One of the more promising developments in recent years, in monetary terms, has been the dramatic increase in remittances. By 2012, for example, remittances were three times the size of ODA. While the trend of financialization has been strengthening, causing greater volatility in the flows of private capital, remittances have been exhibiting, overall, strong and relatively more stable growth.

While five developing economies (India, China, the Philippines, Mexico and Nigeria) accounted for about 40% of all remittance inflows in 2012, there were many other countries that received significant inflows. Moreover, remittances have been of particular importance to many smaller countries and fragile states, such as Tajikistan, Nepal and Haiti.

The flow of remittances to developing economies was indeed impaired by the global financial crisis, particularly the flows to regions dependent on migration to the USA (such as Latin America and the Caribbean) and to Europe (such as Eastern Europe, the Middle East and North Africa). However, regions, such as South Asia, which relied on migration to some of the richer Gulf countries, were not dramatically affected by the crisis. Similarly, the flow of remittances *within* sub-Saharan Africa was fairly resilient. In fact, remittances within this region have been more stable than either FDI or private debt and equity flows.

Trends in the post-crisis period continue to develop and it remains to be seen what the long-term structural consequences of the international financial crisis will be for private

capital flows to developing countries. However, the general assessment of the impact of private capital flows on developing economies has already been undergoing change, not only in academic circles, but also among policymakers in international financial institutions as well as in national central banks and regulatory bodies.

It is now more generally accepted that the impact of private capital flows will depend on a number of key factors, an important one of which will be the character of policy responses of recipient countries. For example, in response to increasing financialization, the developing economies that have the wherewithal to do so have been accumulating sizeable stocks of reserves as a form of 'self-insurance' against the volatility of private capital flows. Also, there has been a growing acceptance among policymakers at both the national and international level that initiatives such as macro-prudential regulations and capital controls could play important stabilizing roles in this arena. Thus, implementing such measures could help provide national governments with some measure of policy independence and flexibility.

Such positive trends could also be strengthened as major emerging economies continue to grow in importance in the global economy and strive to maintain independence in their own policymaking. Such economies are also likely to assert greater influence within international policymaking bodies. For example, in recent years international bodies such as the G20 and the Financial Stability Board have expanded their board membership in order to include rising economic powers such as China and India.

In addition, the economic independence of developing economies has been strengthened by the increasing numbers of South-South economic pacts. The latter have included both regional pacts –such as the Chang Mai Initiative, which established inter-Asian co-operation including among central banks, and the East African Community, which has been seeking greater internal trade cooperation.

However, a noteworthy trend is that a significant number of other developing countries – largely those that are smaller and poorer – have remained largely marginalized from the international financial system. Thus, their underdevelopment has acted as a form of protection against instability. In the future, however, as they seek increasing levels of private capital from international sources, they are also likely to experience greater financial fragility. But, at the same time, they are also likely to be less able to institute the necessary policy safeguards against such an adverse trend. Thus, the overall prognosis for such countries with regard to the impact of private capital flows is likely to more pessimistic.

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THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?'

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5	Pour la Solidarite, Brussels	Belgium
6	Poznan University of Economics	Poland
7	Tallin University of Technology	Estonia
8	Berlin School of Economics and Law	Germany
9	Centre for Social Studies, University of Coimbra	Portugal
10	University of Pannonia, Veszprem	Hungary
11	National and Kapodistrian University of Athens	Greece
12	Middle East Technical University, Ankara	Turkey
13	Lund University	Sweden
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