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Synthesis Report:

Empirical analysis for new ways of global engagement

Carolina Alves, Vivienne Boufounou, Konstantinos

Dellis, Christos Pitelis and Jan Toporowski

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Synthesis Report: Empirical analysis for new ways of global engagement.

Authors: Carolina Alves, Vivienne Boufounou, Konstantinos Dellis, Christos Pitelis and Jan Toporowski

Abstract There has been an increase of private non-guaranteed external debt (PNG) in developing countries and emerging economies in the last two decades reflects the increasing cross border flows of capital. The traditional literature, relaying on the current account, i.e. net capital flows, associates external debt in emerging and developing countries with deficits in current account, and cross border capital flows with global current account imbalances. This paper presents empirical evidences showing that during the 2000s that emerging markets have experienced a surge in private capital flows. As a result, emerging and developing countries cross-border asset positions have correspondingly increased, with the share of private sector claims on emerging markets increasing and the share of liabilities held by government and multilateral institutions decreasing. There is increasing involvement of the private sector in the developing countries' external debt and the fact that the public sector, previously reliant almost entirely on official credit, has become able to access private debt markets reflects the increasing integration of developing countries into the global financial system. Gross capital flows data reveals that net capital flows do not explain and do not capture this global financial integration. The emerging and developing economies are at the margin of the process when it comes to cross-border financial flows that are still very much driven by developed economies, especially the EU and US and are concentrated in only a few countries. The surge in private capital flows within a context of current account surpluses has its mirror image in the accumulation of foreign exchange reserves. In turn this connects the capital flows towards these economies with factors such as the international monetary cycle. Lastly, it is discussed that the growing integration of

developing and emerging countries into the global financial system is also the product of official development policy becoming more supportive of the private sector. The EU Aid policy has relentlessly supported the 'pro-finance' argument to achieve economic growth in these countries. Interestingly, one of the main tools to promote the development of the financial sector in developing countries relies on the notion of 'blended finance', which rests on using public Overseas Development Assistance (ODA) funds to leverage private funds and on developing broader types of public-private partnerships. There is therefore increasing increased integration of Emerging and Developing Economies in the global financial system, emerging 'financialization' in the economic and social development of developing countries and the increased role of the private sector, and inter-dependence between the European Union (EU) and the emerging countries and an assessment on the potential economic and social benefits for European sovereigns.

Key words: Development finance, international capital flows, international monetary cycle, financialisation, sovereign wealth funds, private equity, hedge funds

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Contact details: jt29@soas.ac.uk; chris.pitelis@brunel.ac.uk

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Introduction

The European Union engages with the rest of the world through trade and payments (international money capital flows) and through cross-border capital flows. The first of these lies within the domain of trade and exchange rate policy that lie beyond the scope of this synthesis paper. Cross-border capital flows go mostly between Europe and the other OECD countries with whose financial systems the European financial system is steadily being integrated, in the sense of rising volumes of cross-border assets and liabilities, but also in the sense of rising cross-border ownership and operation of banking and financial institutions.

In the past, the growth of cross-border liabilities was associated with borrowing to finance trade deficits. But, in a world of huge and free capital flows, the external debt in emerging and developing countries is no longer directly associated with deficits in current account. Since the turn of the century, these countries have experienced a surge in private capital flows which, together with the current account surpluses, have their mirror image in the accumulation of foreign exchange reserves. As a result, cross-border asset positions in these developing countries have correspondingly increased, with the share of portfolio liabilities increasing and that of non-portfolio debt liabilities decreasing. This indicates that the current account position only partially explains the patterns of indebtedness of developing countries, and that the growing integration into the global financial system increases their exposure to portfolio investment that may raise different types of financial stability concerns, and submit their economies to different factors driving these capital flows.

The current account balance provides the link between foreign debt sustainability and economic development. According to standard neoclassical models, international borrowing by developing countries should be regarded positively for two main reasons. Firstly, developing countries can finance development with foreign saving. By definition, these countries have lower capital stocks and lower saving rates, resulting in higher real interest rates and lower investment. Importing capital from richer countries, allows lucrative investment opportunities to be financed at lower interest rates and, provides a mutually beneficial arrangement. Here a 'country's resources for external debt servicing each period

can be measured by its trade surplus'. On a long-term perspective, the solvency requirement implies that the discounted value of future trade surpluses must be equal to the current foreign debt. A socially optimal borrowing strategy is to borrow until the marginal product of capital is equal to the world interest rate (Cooper and Sachs, 1984)

The second benefit of international borrowing comes from the 'intertemporal approach to the current account', which sees the balance of payments as determined by forward-looking investment and saving decisions (Obstfeld and Rogoff, 1995). Intertemporal utility out of consumption maximisation gives a result similar to the permanent income theory of consumption: consumption is a stable function of permanent national cash-flow, defined as the discounted sum of future total output minus investment and government expenditure (Sachs, 1982; Ghosh and Ostry, 1995). Current accounts are therefore used as a buffer against temporary shocks in national cash flows. For example a temporary negative shock in national output will not affect the country's permanent cash flow, thus leaving current consumption unchanged. As a result the country borrows to smooth consumption, due for example to a permanent productivity shock, thus running a current account deficit.

In either case, the current account imbalances and the resulting accumulation of foreign debt need not be a cause of concern within this framework, as if developing countries borrow from abroad, they are either financing investment exploiting the lower cost of foreign capital, or they are trying to smooth consumption in anticipation of higher future incomes[1]. The corresponding policy view, known as the Lawson doctrine[2], maintained that, so long as current accounts deficits were originated in the private sector, the resulting liabilities were hedged in the private sector and therefore are not a cause for policy intervention.

Empirically, the balance of payment and currency crises that hit emerging and developing countries in the early 80's and then in the late 90's challenged this consensus. Authors began to question the relevance of the inter-temporal approach to the current account and the associated Lawson doctrine. Consequently current account deficits came

[1] See Bonizzi, Laskaridis and Toporowski (2015) for more details.

[2] From the name of Nigel Lawson, chancellor of the Exchequer in the late 80's, who firstly expressed this view.

under closer scrutiny[3]. For example, indicators of sustainable current accounts were deemed sustainable if they were consistent with the solvency requirement, i.e. if they implied a long-run stable ratio of external liabilities to GDP (Reisen, 1998; Milesi-Ferrett and Razin, 1998; Edwards, 2001). Historical evidences of current accounts deficits and their association with crisis were showed through the works of Milesi-Ferrett and Razin (1998) and Edwards (2001), for instance. Furthermore, the existence of account deficits and their reversal as a result of a sudden stop in net capital flows were theorised as the canonical crisis mechanics (Calvo, 1998).

The discussion on current account deficits, or lack thereof, remained a central research topic in the 2000's. The capital flows "puzzle" literature, for example, highlights that that in net terms capital flows "uphill" from developing countries to advanced countries (Gourinchas and Jeanne, 2007; Prasad et al., 2007). Kose et al. (2003) document that financial openness, which was supposed to allow countries to fully exploit the consumption-smoothing function of current accounts, seems to be positively associated with *higher* consumption volatility, especially in lower-income countries. Blanchard and Milesi-Ferretti (2009), prominent IMF economists, closely relate the development of global current account imbalances to the build-up and evolution of the global financial crisis, and suggest that their further reduction is a necessary condition to the post-crisis economic recovery.

While sometimes maintaining opposite opinions on the importance of current accounts for financial and economic stability, the debate summarised above seems to share a common belief: the current account is the key driver of changes in foreign debt and foreign liabilities more in general. The focus therefore should be on *net* external liabilities, just as the current account focuses on *net* capital flows. This view has however been challenged by both empirical evidence and theoretical arguments, especially due to the trends of financial globalisation.

The path-breaking work of Lane and Milesi-Ferretti (2001) and subsequent related works (Lane and Milesi-Ferretti, 2003; 2007; 2008) document that the expansion of cross-

[3] See Reisen (1998)

border asset holdings over the past two decades, and in the 1990's decade in particular has been unprecedented, and, while it occurred mostly between advanced countries, emerging and developing economies have also experienced increasing degree of financial integration. This trend has given rise to a series of empirical regularities. Firstly, in general, gross cross-border holdings and financial flows are several orders of magnitude bigger than their corresponding net figures (Obstfeld, 2012b; Brunnermeier et al., 2012). Secondly, the accumulation of foreign assets has increased the importance of capital gains and losses on international investment positions (Lane and Milesi-Ferretti, 2007).[4] Thirdly, emerging and developing countries have accumulated more diversified liabilities – with more private debt and equity-like liabilities as opposed to the past concentration on public debt liabilities – as well as accumulating external assets, primarily in the form of foreign exchange reserves by central banks. Overall, their net foreign asset position seems to have improved in the decade preceding the global financial crisis (Lane and Milesi-Ferretti, 2007).

Alongside these empirical observations, 'new' theoretical arguments were proposed in favour of focusing on gross rather than net flows and positions (Johnson, 2009; Borio and Disyatat, 2011; Broner et al., 2011; Bruno and Shin, 2013). Borio and Disyatat (2011) argue that, for the analysis of international financial relations, focusing on the current account is unjustified. Current accounts, by definition, only measure the transactions that relate to trade in goods and services and income transfers, while all the other asset transactions are excluded. In their view this arises out of confusion between saving – unspent income - and financing – a cash flow concept. Investment, like most economic activities, does not require saving but financing, which can be found domestically or internationally, in the latter case generating a cross-border money flow as a result of which an institution in the lending country will have a claim (a loan asset) on the borrower and the borrower will have a claim on the lender (a bank account credit, which can be transferred to other agents). As a result, current accounts are not necessarily tied to any specific gross flows nor any specific

[4] Such "valuation effects" have been subject of a vast literature, seeking to analyse their role as an alternative balance of payment adjustment mechanism (Gourinchas and Rey, 2005; Cavallo and Tille, 2006; Devereux and Sutherland, 2010).

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domestic activities and therefore it is wrong to assume that a current account surplus is "necessary" for reserves accumulation or that current account deficits are necessary to finance investment internationally.

More specifically, when analysing cross border capital flows based on national saving-investment, financial transaction, i.e., borrowing and lending, are combined with national concepts that track expenditures on final goods and services. However, as mentioned above, investment, and expenditure more generally, require financing, not saving. More importantly, in general, 'the changes in financial assets and liabilities in any given period bears no relationship to saving (and investment) in the national accounts sense … typically, increases in assets and liabilities greatly exceed saving in any given period, reflecting in part the myriad of ways in which expenditures are ultimately financed' (Borio and Disyatat, 2011, pp.7-8). Essentially, based on the intertemporal equilibrium approach to current account as formalised in the 1990s by Obstfeld and Rogoff (1995), the current account framework analysis of the origin and direction of financing, with surplus countries lending to deficit ones, relies on identities that track resources flows, but are silence about the underlying financing of those resource flows (Borio and Disyatat, 2015, pp.4-5).

In this light, saving-investment balances, current accounts and net capital flows analysis reflects on a small part of the global financial flows. The net financial flows that arise from trade in real goods and services 'exclude the underlying changes in gross flows and their contributions to existing stocks, including all the transactions involving only trade in financial assets, which make up the bulk of cross-border financial activity' (Borio and Disyatat, 2011, p.8). Very often, gross flows need bear no relationship to the net flows in the current account balance and are generally much larger than the latter. Furthermore, the current account balance of payment framework places the foreign exchange reserves as a subcomponent of gross outflows and very often current account surplus is tied up to accumulation of foreign reserves. However, in general, this is an arbitrary match, as gross flows typically exceed net flows and the accumulation of foreign exchange reserves is generally a purely financial transaction. The accumulation of foreign reserves is the results of countless domestic players acquiring foreign assets at any given point in time for different

reasons,[5] and, empirically, countries running current account deficits do accumulate large amount of foreign reserves (Borio and Disyatart, 2011, pp.9-12).

The conclusion is that global imbalances in current account do not explain a country's cross-border financing activity in its entirety. Expenditures could be financed entirely at home or abroad, regardless of the current account position. Equally important, when assessing capital flows, and more specifically, global financing patterns, it may be necessary to move away from the residency principle, which underlies the balance-of-payments statistics, to a perspective that consolidates operations of individual firms across borders (Borio and Disyatat, 2015, pp.1-2).

These arguments inspired a new theoretical and empirical research into the dynamics and consequences of gross capital flows. For example, both gross inflows and outflows typically move pro-cyclically, and crises tend to involve sharp reductions in both (Broner et al., 2011). Sudden stops of gross flows, whether or not resulting in net sudden stops, may be very damaging to the economy (Cavallo et al., 2013). Financial vulnerabilities are largely related to gross capital flows and the salient trends in international banking activity, which, in turn, is largely unrelated to – or, at the least, not captured by – global current account imbalances is not are largely related (Borio and Disyatat, 2011)

The analytical emphasis on gross flows and cross-border holdings, along with the stylised facts of financial globalisation, suggest a different line of inquiry into developing and emerging countries external financing needs. Alongside traditional indicators, such as current accounts and trade balances, the evolution of developing and emerging countries external debts should be analysed in relation to their integration in the global financial system, and changes in the maturity structure of that debt, reflecting refinancing and hedging requirements independent of any current trade imbalance. Consequently, any assessment of the vulnerability of such external positions must take into account the characteristics of such integration, which may raise different issues than the common balance of payments vulnerabilities.

[5] The causes of foreign exchange reserves accumulation can be variously explained. See deliverable 6.01 for an overview of the debates

The developing and emerging countries external financing needs, and their integration into the global financial system, has also been influenced by the Aid policy of the European Union, which has placed financial deepening at the heart of its development policy. The relationship between financial and economic development has been one of the most debated topics in the literature over the past two decades. The conventional starting points of this literature are McKinnon's (1973) and Shaw's (1973) arguments against financial 'repression' in developing countries, seeing it as a key impediment to development. These arguments were quickly incorporated into the 'Washington consensus' and, indeed, financial liberalisation policies became common into the structural adjustment reform packages. However the mixed success of the actual experiences with liberalisation (Dornbusch and Reynoso, 1989), including the early financial crises in developing countries (Diaz-Alejandro, 1985), was coupled with theoretical challenges. The mechanics of financial markets were questioned by market imperfection hypotheses (Stiglitz and Weiss, 1981; Stiglitz, 1994; Stiglitz, 2000), which posed a threat to the basic relationship between finance and economic development. Stiglitz (1994) in particular argued that asymmetric information problems are inherent to financial markets, and that liberalisation may exacerbate rather than solve them, thus maintaining that state intervention is essential to well-functioning markets. As a result, the financial liberalisation literature began morphing into one in which the benefits of financial liberalisation would only occur with a few provisos (World Bank, 1991).

By 1990 the Washington Consensus was already morphing into the nascent Post-Washington consensus, and central to the emergence of the good governance agenda that characterised the trajectory of development policy[6] was the view that the state's role is to foster the development of the market. The 'sequencing' approach to financial liberalisation clearly echoes these post-Washington views. Even more fundamental was the emergence of the concept of 'financial development'. This literature developed a new paradigm about the finance-growth nexus, seeking to overcome previously highlighted flaws and positing a more definitive case for the role of the financial sector in fostering economic development (King

[6] See the influential paper by the World Bank (Corden et al., 1993), which emphasized the role of the state in accomplishing the 'Asian miracle'.

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and Levine, 1993; Pagano, 1993; Levine, 1997). It is argued that a more developed financial sector can perform such functions more efficiently, and better overcomes the informational asymmetries that may otherwise be pervasive in financial 'backwards' countries. Such functions could even have wider welfare effects than just economic growth: finance was linked to poverty reduction and lowering income inequality (Honohan, 2004; Dehejia and Gatti, 2005; Beck et al., 2007). The key was therefore to ensure financial development could be accessed by all parts of society, shifting the focus to 'access to finance'.[7]

These academic developments were in line with the direction of the IFIs' policy consensus, which was increasingly focusing on poverty reduction.[8] The SDGs indicate the confluence of global development policies since the early 1990s. The discussion on the lending policy of the international financial institutions (IFIs – the World Bank and the International Monetary Fund) has now converged with the discussion around the financing of economic development. Basically, the process of realigning and recreating shared aims across the international development institutions has been accompanied by the parallel and complementary discussion about how a comprehensive financing framework will make the achievement of the new aims possible. It is within this changing context that Member States, development agencies, the UN processes and international financial institutions are

[7] Other policies could in fact become justifiable insofar as they increased 'financial development': for example, capital account liberalisation was to be pursued for the 'collateral benefits' it could give a country, including the development of the financial sector (Kose et al., 2006).

[8] The IFI's policy consensus itself came a long way in seeing the importance of financial development for something wider than simple GDP growth. It goes back to the changing landscape of international development policy formation and practice, which can be seen by retracing the United Nations Development Programme (UNDP) first Human Development report in 1990. This report was seen as offering a counter-weight to the content of international development as seen in the Structural Adjustment Policies that were blindly pursued by the IFIs at the time. By the mid-1990s it was possible to identify a focal point of international development cooperation: poverty reduction and eradication had emerged from the UN process as a key goal, and by the year 2000 positions related to this crystallized around the eight Millennium Development Goals (MDGs). Twenty-five years later, the newly set Sustainable Development Goals (SDGs) aimed at a significant broadening out of the MDGs. This enlargement of goals means that poverty eradication, which had previously defined the core of the MDGs is now augmented by broader economic, social and environmental goals that are seen as crucial in order to achieve the stated aim of poverty eradication.

engaging in a discussion that seeks to address how the newly agreed common goals for international cooperation in development will be financed.

The key summit that laid this new financing framework was the Third International Conference on Financing for Development, Addis Ababa July 2015. The conference aimed at a global framework for financing development post-2015 that is squarely on the role of public-private cooperation and the need to catalyse broader resources for development. In particular, blended finance, inspired by the World Economic Forum and OECD initiative on ReDesigning Development Finance,[9] gained significant traction throughout the Conference and the International Business Forum[10] as a promising path to achieving the Sustainable Development Goals. [11]

This shows that the international discussions that are currently underway emphasise and focus on the role of private financial flows in bringing about developmental goals. In particular, the flows to banking and financial sectors are seeing as an integral and increasingly dominant aspect of policy and practice.[12] In the level policy circles, mobilising private cross border financial flows have been seen as crucial in bringing about eradication of poverty, as well as in financing the broader set SDGs. However, in some respect, mobilising private cross border financial flows and financial deepening have become developmental ends in and of themselves. The lack of access to capital markets that most low income countries face, and the vast amounts of funds managed by institutional investors

[9] For more details on the blended finance mechanism see World Economic Forum (2015).

[10] An International Business Forum, the largest ever global gathering of high-level business leaders in the development context (with over 800 registered participants), was held in conjunction with the Third International Conference on Financing for Development. The forum was considered history-making as "discussions were anchored in a 21 century model of development cooperation that moves away from traditional forms of aid toward ground-breaking models of public-private investment and action that deliver sustainable, scalable development solutions" (United Nation, 2015a, no pagination).

[11] See specially paragraphs 43, 48 and 54 in the final United Nations (2015) report of the third International Conference on Financing for Development - Addis Ababa.

[12] This rhetoric has been helped by the growing frustration towards the ability and effectiveness of international public financial flows (which largely consist of bilateral or multilateral ODA) in bringing about developmental outcomes.

are seeing, for example, as needing to be bridged so that developing countries can better access these latent funds that could catalyse development. The rhetoric regarding development becomes a simplified application of increasing private sector flows and overcoming the barriers that have been holding back investments.

At one critical end of the debate, it was argued that poverty and welfare issues were being used as pretexts to deepen the pro-market policy agenda (Öniș and Şenses, 2003).[13] Additionally, in the aftermath of the global financial crisis, some authors renewed[14] concerns about the 'financial development story', arguing that 'too much finance' is harmful to economic growth, regardless of any other institutional quality issue (Berkes et al., 2012; Law and Singh, 2014). Also, the emerging literature on financialisation in developing countries (see Bonizzi, 2013 for a survey), which has gained momentum after the crisis, has presented theoretical arguments and empirical evidence of how over-rapid expansion of the financial sector in developing counties may be harmful to their long-run developmental goals. Despite these claims, the consensus remains relatively strong, with current papers claiming that the growth of the financial sector is conducive to economic growth in developing countries (Beck et al., 2014). In any case, although the academic discussions have long raised concerns, the policy proposals have been hardly changing, and the 'financial development' consensus remained prominent during the 2000s, now with an emphasis on the need to innovate financial instruments and techniques in order to pool public and private funds together.

The 'pro-finance' arguments about economic development have affected the Overseas-Development Aid (ODA) provision in general, and the EU Aid policies in particular. The importance of finance within the EU aid policies can be traced on two levels. Firstly, an important and growing part of the EU ODA is directed at the promotion of the development of the financial sector in developing countries, which very often includes promotion of private

[13] For example, the resignation of the chairman of the team preparing the World Bank's World Development Report on poverty in 2000, Ravi Kanbur, who presented a broader understanding of poverty linked to global structural unequal relations, could be seen as an intolerance towards alternative poverty-reduction proposals that were not free-market oriented.

[14] Similar arguments were in fact made a decade before (Arestis and Demetriades, 1997; Demetriades and Hussein, 1996)

sector for-profit activities. This is particularly the case of aid directly channeled by EU-level institutions. Secondly, the provision and funding of aid has become more closely associated with the private financial sectors. In this respect, the EU development policy, in line with the global focus on innovative techniques of aid provision, is pioneering the notion of 'blended finance', which rests on using public ODA funds to leverage private funds and on developing broader types of public-private partnerships. Although this is not a new practice, the emphasis on it is significantly greater than previously. These two aspects highlight how even cooperation policies with developing nations cannot be considered immune to the process of financialisation

To start the analysis of a different line of inquiry into developing and emerging countries external financing needs, this report summarises the foreign debt situation of developing countries Some features of financial integration in developing and emerging countries are discussed in the light of the foreign debt situation of these developing countries. Finally, a further analysis of financial globalisation contesting the traditional literature on international borrowing and highlighting a few aspects that underlines the current financial integration of developing countries is offered. Here attention is shifted towards gross flows and the concentration of the debt in a few countries.

The new finance opportunities that have emerged in many developing countries have contributed to the surge in private sector indebtedness steadily over the past years for most of the regions receiving aid funds. This trend provides with extra funds to be distributed to the much needed investment projects, nevertheless it raises concerns over the volatility of short term capital flows and the adverse impact of a potential negative shock to the recipient economies. Despite the fact that current accounts are improving for the vast majority of developing economies , thus decreasing their net indebtedness, the augmentation of gross debt needs to be taken into consideration.

The increased participation of emerging and market economies in the global financial system is a source of new developments and opportunities for new multilateral relationships. These economies with the proliferation of BRICs can provide with an array for investment opportunities with their growing hedge fund, private equity and venture capital markets.

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More importantly, however, they can prove to be a source of finance for Europe in a time of financial distress and serious disinvestment in the region. This opportunity stems from the evolvement and growth of Sovereign Wealth Funds with large capacity to invest as well as through the accumulation of Euro-denominated reserves and Foreign Direct Investment originating from emerging economies. This scenario does not unfold without caveats as FDI and reserve accumulation are affected by the adverse macroeconomic developments in the EU and the political risks of the involvement in Europe of SWFs from China and Russia are not negligible.

1. Developing Countries' Integration in Global Financial Markets

1.1 The role of the private sector in EU development policy

The first section of this paper delves into the evolution of EU Development policy. More specifically, it addresses the issue of 'financialization' in the economic and social development of developing countries and the increased role of the private sector in the process of aid. For the European Union this development has culminated since the beginning of the century through the policy directives that govern aid provision, namely the **EU Consensus on Development** of 2005, the **Agenda for Change** statement of 2011 and the **Decent Life for All** initiative of 2013. The shift in the rules governing the relationships between the EU and developing countries is in vein with the notion that a deep and functional financial sector can promote economic growth and development (King & Levine, 1993). Furthermore, moving from the Millennium Developmental Goals (MDGs) to the Sustainable Development Goals (SDGs) financial development is perceived as a pivotal force in achieving sustainable development and alleviating poverty. The 'financialization' of EU aid policies can be broadly seen as unwinding in two ways. First, a growing proportion of aid funds is directed to the financial sector to promote its growth and, second, public overseas-development aid (ODA) funds are used to leverage private funds in the form of 'blended finance'. The latter practice has gained traction over the past years significantly increasing the available funds provided along with ODA. The profound role of finance and private capital in the developmental process raises questions on the hypothesized positive effects of financial liberalization (Stiglitz, 2000) as well as the motivation behind the involvement of the private sector through the leveraging process.

The elevated role of finance in the development process and the aid provision on behalf of the EU is evident in the SDGs as well as the Agenda for Change and the Decent Life for all declarations. More specifically, the SDGs include the effort to 'Strengthen the capacity of domestic financial institutions to encourage and expand access to banking, insurance and financial services for all' as well as ' Increase the access of small-scale industrial and other enterprises, in particular in developing countries, to financial services, including affordable credit, and their integration into value chains and markets'. Largely based on the literature

highlighting the finance-growth relationship (see Levine, 2005) the SDGs cast focus on financial institutions and access to credit for small and medium-sized enterprises (SMEs) as a driver for structural transformation of the societies.

1.2 Finance and Development

Nevertheless, the positive feedback from financial liberalization to economic growth and development has had its numerous critiques though. Even before the prevalence of the Washington Consensus, James Tobin warned that the social returns of the financial sector are substantially lower than the private ones and that finance "steals" talent and resources from more productive sectors of the economy. Stiglitz (2000) arguably attributes the East Asia crisis of the late 1990s to capital flow liberalization and relevant policies mandated by the IMF. Sachs (2000) highlighted that the crisis was not one of flawed economic fundamentals, rather the result of ill-suited liberalization policies. Rodrik (2011) concludes that " financial globalization has failed us" by exacerbating the risks of volatile short-term flows for countries opening up their financial account to international markets.

As far as the empirics of the relationship are concerned, Arcand et al. (2012) use both cross-sectional and panel data to find an inverse U relationship between credit to the private sector and economic growth. According to their calculations, the threshold lies somewhere between 80 and 100% of GDP. After that, the pitfalls of increased volatility exceed the positive effects on growth. Easterly et al. (2000) find a convex relationship between financial depth and output volatility. The relationship is non-monotonic according to Demetriades & Law (2006) who state that a deep financial sector does not enhance economic development in countries with poor institutions. The importance of the functioning of institutions in reaping the potential benefits of capital flows is also stressed in Kose et al (2006) who also spot threshold effects in exchange rate policies, trade openness and the development of local financial markets. Rodrik (2011) postulates that in the light of the recent financial crisis more financial globalization is not necessarily better and that national ad multilateral policies have an increased role to play in this context.

1.3 Trends in Developing Countries External Debt

1.3.1 General Trends

External Debt can be growth enhancing for developing economies according to neoclassical theory for two reasons. First, given the low level of domestic saving and high real interest rates, external finance provides with the necessary capital to invest in key areas for economic development at a low interest rate. Moreover, based on the 'inter-temporal approach to the current account' (Obstfeld & Rogoff, 1995) borrowing from international markets, thus is supposed to finance a current account deficit, allowing economic agents to smooth consumption over time. Since current account deficits are created by the private sector and help finance productive investment and smooth consumption they should not be viewed as a problem. This view on external policy is known as the Lawson doctrine. The accumulation of foreign debt does not pose a threat to sustainability as long as the discounted value of future trade surpluses is equal to current external debt [15](Cooper & Sachs, 1984). The Lawson doctrine has gained substantial criticism due to the trends of financial globalization over the past twenty years. In particular, scholars have proposed shedding light on gross rather than net positions for developing countries (Johnson, 2009, Bruno & Shin, 2013).

The main empirical fact that contributed to this change in approach of external finance was that cross-border asset holdings have seen an unprecedented surge beginning in the final decade of the 20th century and emerging economies have been an integral part of this process (Lane & Milesi-Ferretti, 2001). This has posed some serious implications for the way the literature assesses the Balance of Payments stance. Firstly, as underlined by Obstfeld (2012) financial flows have been systematically larger than their corresponding net figures. Secondly, foreign asset accumulation has brought capital gains and losses on international investment positions to the epicentre of the external adjustment mechanism (Cavallo & Tille, 2006). Finally, the traditional dominance of public foreign debt has been questioned by the recent diversification of liabilities and the growth of private debt and equity-like liabilities as

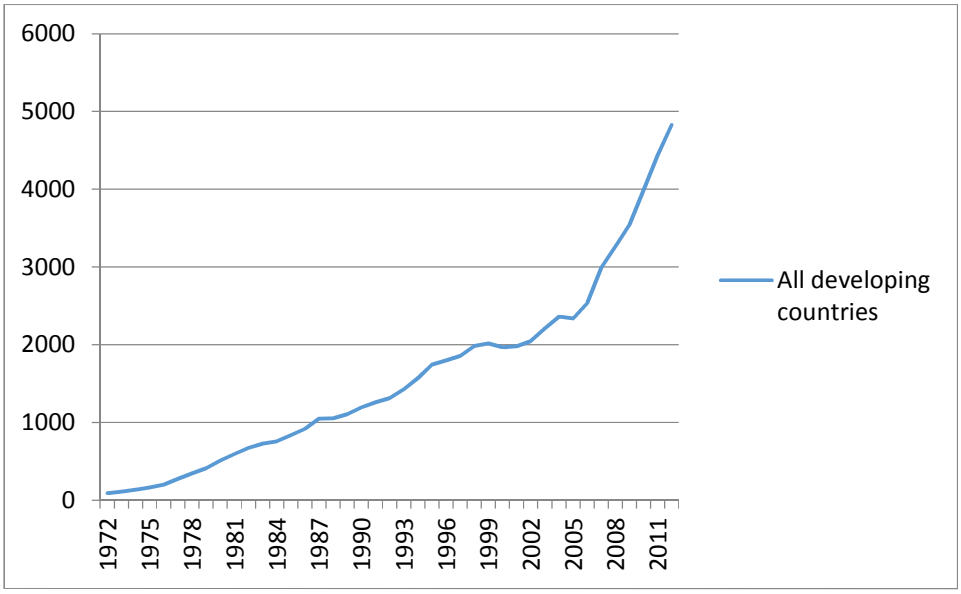
[15] This result is known as foreign debt sustainability

well as the accumulation of foreign exchange reserves by the central banks. According to Cavallo et al. (2013) the pro-cyclicality of both gross inflows and outflows makes them prone to financial crises and can contribute to increased volatility for the developing economies. These developments stress the need to complement the traditional indicators of current accounts and trade balances with data on external debt and the process of integration in the global financial system. The following section addresses this issue by presenting data and stylized facts on the external position of the developing world.

1.3.2 External Debt - Stock and Service

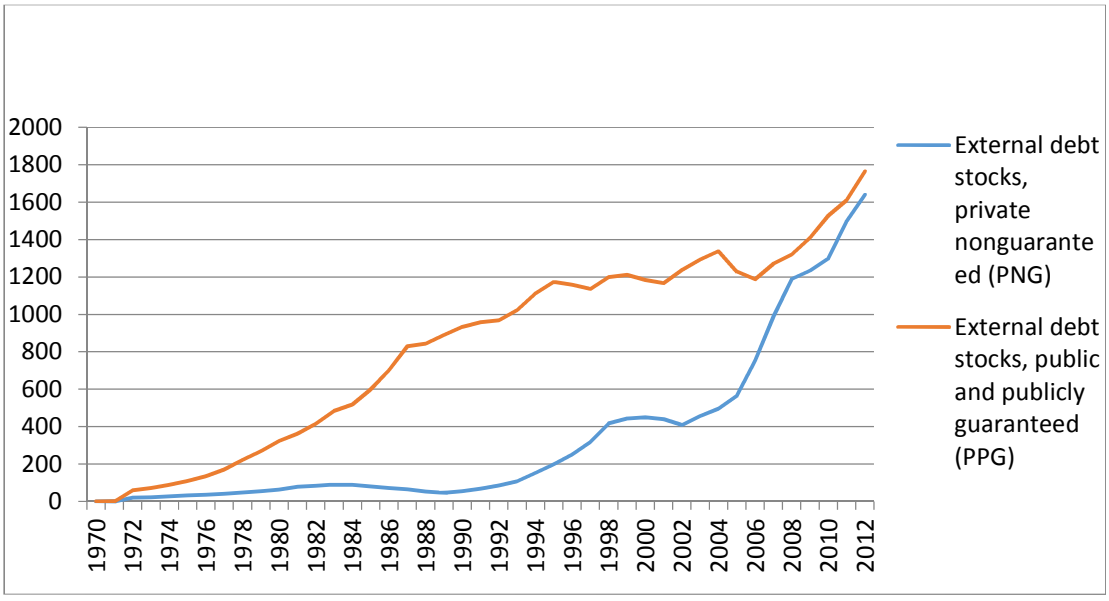
The steady increase in the external debt for the developing countries since the 1970s with a sharper rise after the beginning of the new century as depicted in Figure 1.3.1. The notable shift in the composition of external debt takes place after 1990, by which the private sector gradually increases its share over total external indebtedness. Figure 1.3.2 marks this evolution, which is mostly attributed to debt-financed FDI in emerging markets and debt-financed mergers and acquisitions. Turning to the servicing of debt, private non-guaranteed (PNG) debt service has surpassed public and publicly guaranteed debt service. Nevertheless, the share of debt service (interest payments) as a percentage of either GNI or total exports of goods and services has declined after 2000 looking at the aggregate measures for all developing economies.

Figure 1.3.1: Total External Debt (USD million)



Source: IMF

Figure 1.3.2: PNG and PPG Debt Stocks - All Developing Countries

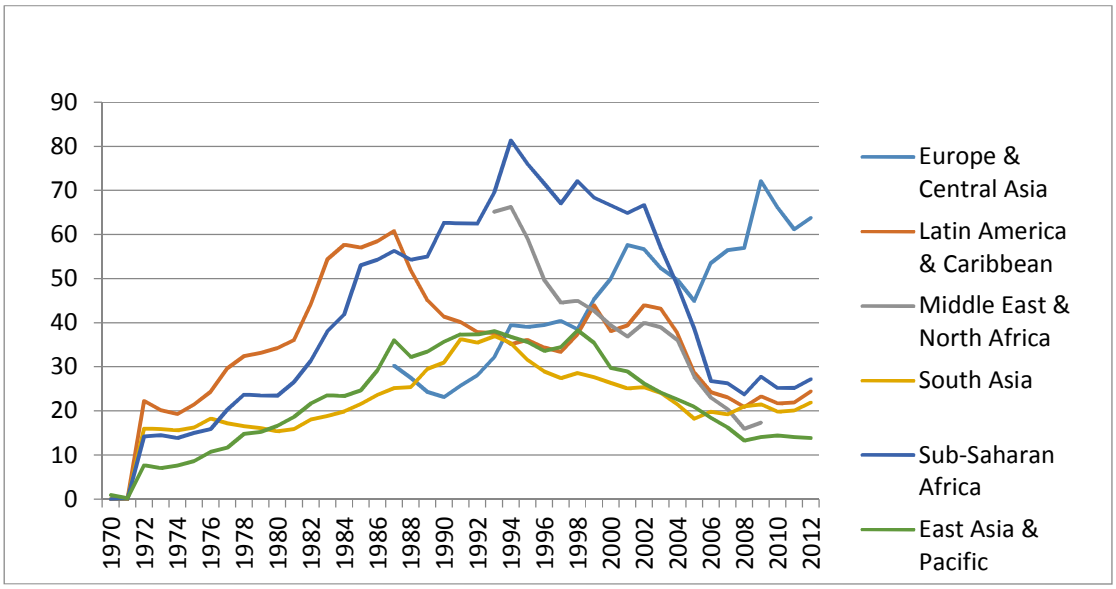


Source IMF

Predictably long-term private external debt has risen sharply for upper and lower middle income economies after 1990 and has remained relatively stable for the low income country group. Furthermore, despite the fact that debt stocks have kept rising even after the

onset of the financial crisis of 2008, the concomitant increase in developing countries' GDP has led to falling external debt as percentage of GNI in all regions except for Europe and Central Asia (ECA) as shown in Figure 1.3.3 below.

Figure 1.3.3: External Debt % GNI - Regions



Source: IMF

Overall the regions with the highest external debt stock are Latin America and the Caribbean (LAC), ECA and East Asia and Pacific (EAP). In terms of maturity, long-term debt accumulation prevails in all regions with the exception of EAP, where rapid short-term debt accumulation began after 2000.

The relative increase in the share of the private sector is clearly linked to financial globalization and capital account liberalization. Private non-guaranteed debt has exceeded public or publicly guaranteed debt since 2004 for the ECA region with bank loans representing the largest part. Even though the total levels are small, long-term private sector indebtedness has shown an upward trend since 2002 for the Sub-Saharan Africa (SSA) region. Latin America and the Caribbean is a region with traditionally high levels of external debt. While the public sector keeps a steady pace in external borrowing, the private sector has reached similar levels of indebtedness mainly through commercial bank loans from abroad. Middle East and North Africa (MENA) is the region with the lowest levels of external

debt and the private sector borrowing is still negligible. The public sector is mostly responsible for the steep rise in borrowing in the South Asia (SA) region after 2005, however the private sector is keeping pace increasing its liabilities abroad. Finally, it is noteworthy that half of the external debt is short-term for the EPA region, complemented by the fact that the private sector has overcome the public sector in terms of borrowing since 2010.

1.3.3 Debt Sustainability

Having stressed the inadequacy of net external positions as expressed for example in the trade balance and the current account we look at sustainability indicators proposed by the Enhanced HIPC Initiative and Debt Sustainability Framework constructed by the IMF and the World Bank. Under the HIPC initiative sustainability is defined as:

1. the value of debt to exports not exceeding 150%
2. the value of external debt to budget revenue being under 250%
3. the proportion of debt service to export earnings being less than 15-20%

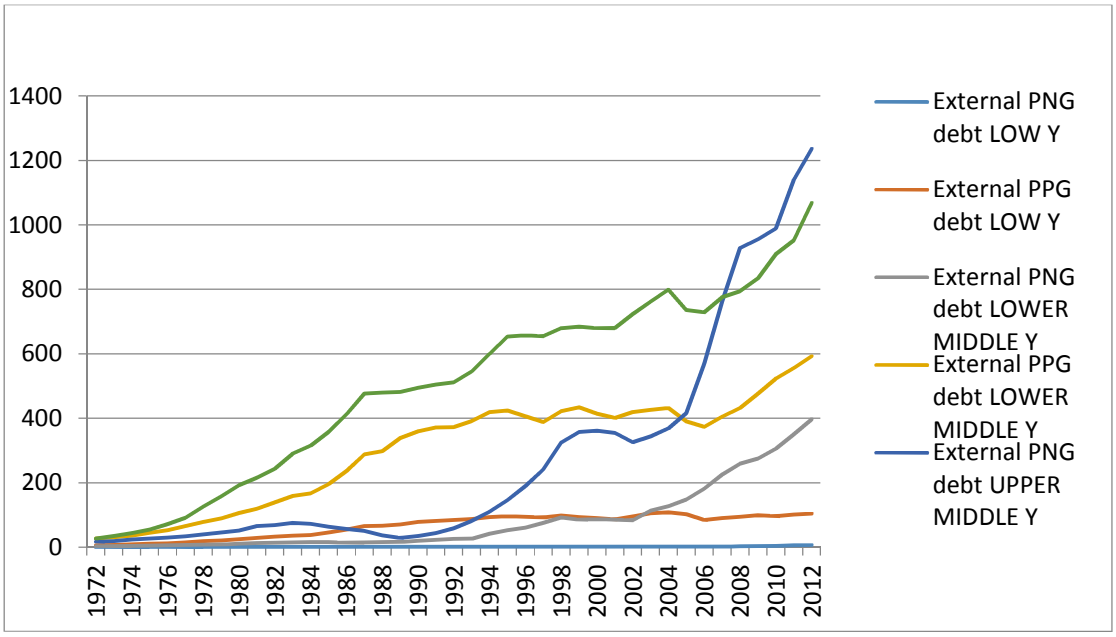
The Debt Sustainability Framework on the other hand relates the debt targets to the quality of institutions in the country. For example, for a country with poor institutional quality the maximum level of external debt service over government revenues is 25%.

The only region not to meet the first criterion after 2005 was Europe and Central Asia with the latest data (2012) showing external debt at almost 1150% of exports. LAC and ECA regions have also breeched the threshold for the debt service as a proportion of exports, nevertheless the value for LAC has fallen below 20% after 2005. All regions have stabilized the proportion of debt service to budget revenues after 2005 with the highlighted exception of ECA where the indicator is close to 70% (2014). A special note has to be made for the top ten borrowers out of the 124 countries that constitute the sample of developing economies. China, Brazil, India, Mexico, Turkey, Indonesia, Hungary, South Africa, Kazakhstan and Ukraine account for 65% of total external debt.

The penetration of the private sector in the borrowing process is not uniform among emerging economies. As described in Figure 1.3.4, upper middle income countries have higher total levels of external debt and are dominated by PNG borrowing after 2006. Private sector debt has gained some ground within the lower middle income group but still lags

behind PPG borrowing, while the external indebtedness is still dominated by the public sector in the low income group of countries. More specifically, the data clearly show that PNG debt is concentrated in selected destinations in the ECA and LAC regions. The distribution among countries is presented at Figure 1.3.5.

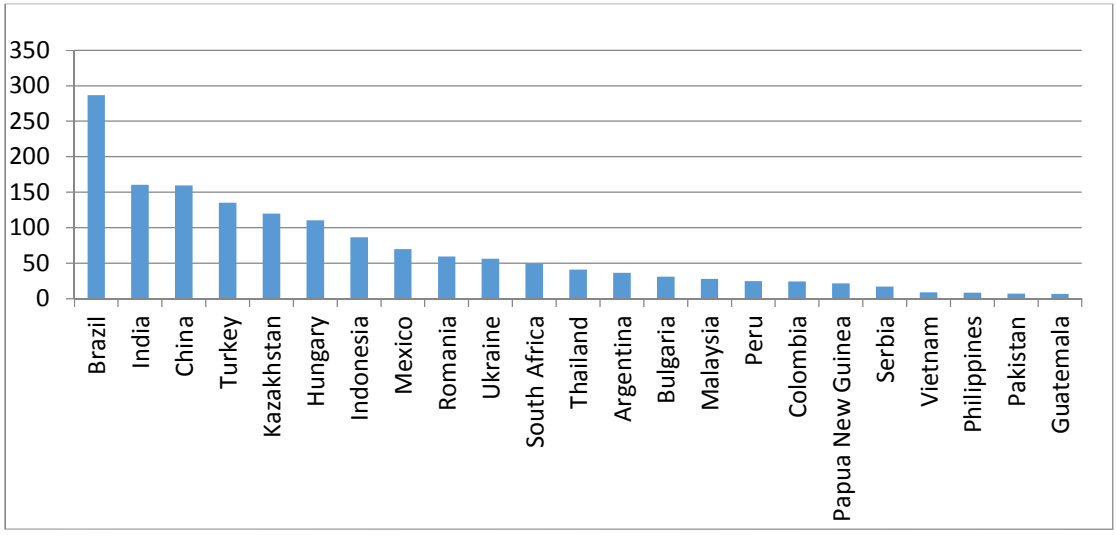
Figure 1.3.4: Sector Decomposition of External Debt - Income Groups



Source: IMF

Upper middle income countries also exhibit a higher share of short term debt compared to total external debt, whereas the situation has remained stable for the other two income groups. Countries belonging to the upper and middle income groups have, on average, increased their reliance of IMF credit substantially after 2007.

Figure 1.3.5 : External PNG Debt (USD Billions)



Source: IMF

1.3.4 Concentration of debt

Although the scenario depicted does identify various trends in the external Private Non-Guaranteed debt (PNG) of developing countries, the diversity cannot be overstated. The two regions, Europe and Central Asia (ECA) and East Asia and Pacific (EAP), where PNG has surpassed the Public and Publicly Guaranteed debt (PPG), include six out of the ten countries[16] that (out of the 124 countries that report to the WB IDS) comprise 65% of the of total developing country external debt. ECA, with 22 countries,[17] has Turkey, Hungary, Kazakhstan and Ukraine. EAP, with 17 countries,[18] has China and Indonesia. Latin America and the Caribbean (LAC), where the PNG is close to surpassing the PPG, has Brazil and Mexico. Furthermore, ECA has five out of the top ten countries concentrating large sums of PNG in absolute terms.[19] Then two are in LAC, two in EAP, and one in SA (figure 18). This in

[16] See note 25.

[17] Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Georgia, Hungary, Kazakhstan, Kosovo, Kygyz Republic, Macedonia, FYR, Moldova, Montenegro, Romania, Serbia, Tajikistan, Turkey, Turkmenistan, Ukraine and Uzbekistan.

[18] Cambodia, China, Fiji, Indonesia, Lao PDR, Malaysia, Mongolia, Myanmar, Papua New Guinea, Philippines, Samoa, Solomon Islands, Thailand, Tonga, Vanuatu, and Vietnam.

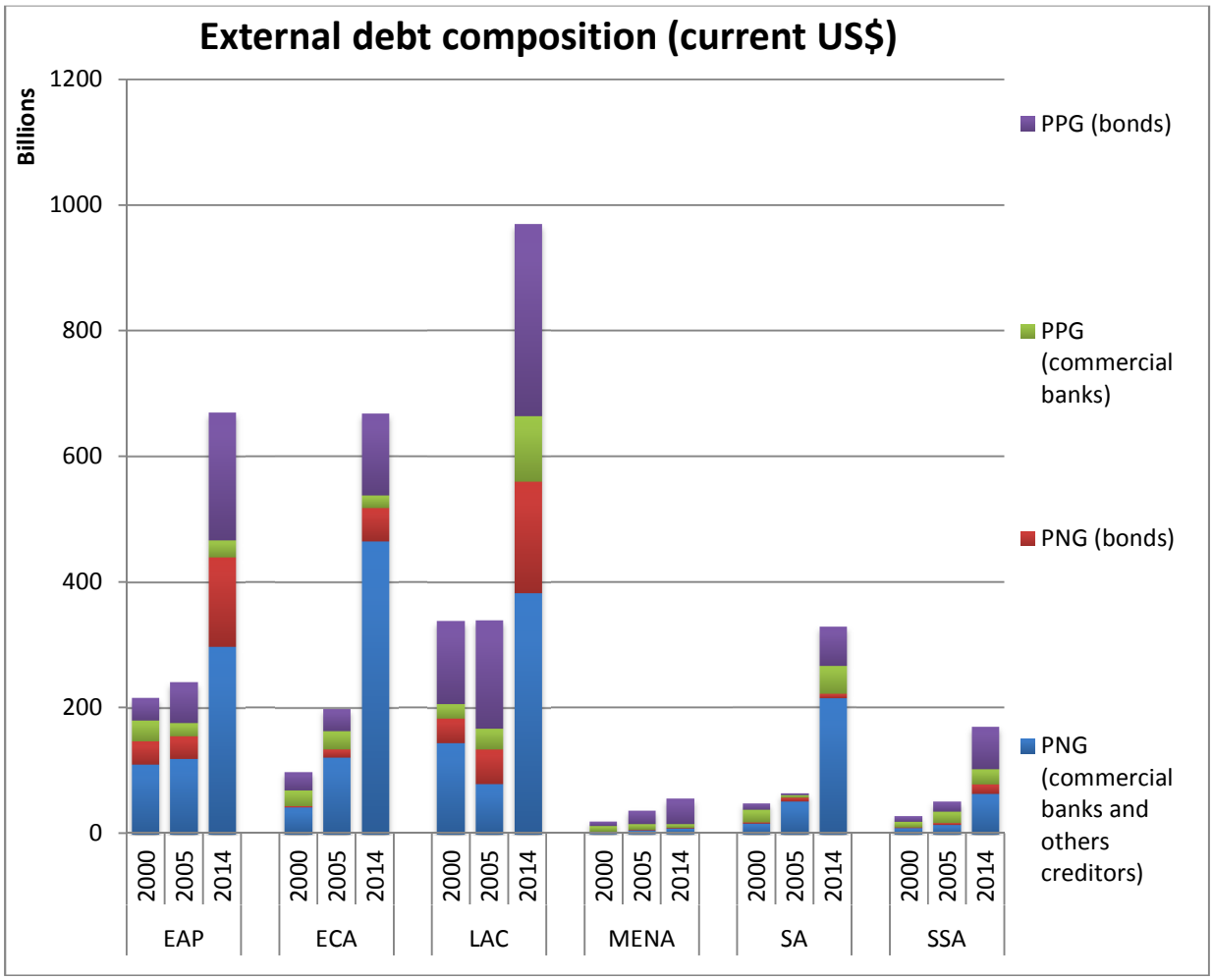
[19] These countries are, by ranking: Brazil, India, China, Turkey, Kazakhstan, Hungary, Indonesia, Mexico, Romania, and Ukraine.

fact explains the chart showing that ECA, LAC and EAP are the regions attracting the highest PNG levels, followed SA. SSA and MENA regions do not attract much external PNG debt (figure 19). Nevertheless, the overall tendency in all developing countries, and in the analysis by regions, may be masked by the large volume of debt flows of a few countries, and is very likely to be driven by a handful of countries.

1.3.5 Financial globalization and the increase of private financial flows

Over the past ten years, not the total external debt stock has increased in emerging and developing countries, but the importance of private sector external debt has growing (Figure 1.3.6).

Figure 1.3.6 Composition of External Debt



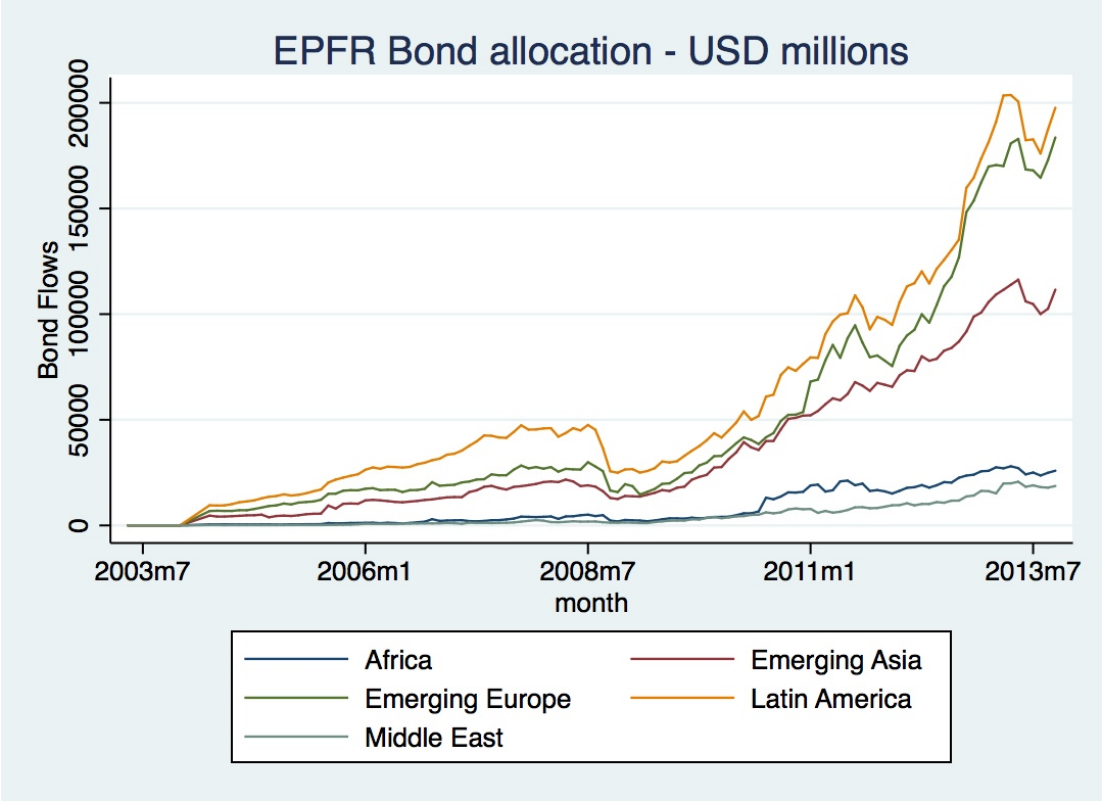
Source: IMF

Figure 1.3.6 above gives a breakdown of regions' external debt. Official multilateral and bilateral creditors were not included. The presence of private creditors in the public and publicly-guaranteed (PPG) debt has increased in all regions since the 2000s. The private non-guaranteed (PNG) debt has substantially increased as well, as already indicated previously. While most of this is commercial bank debt, private sector bonds have also grown over-time. The regional breakdowns of long term external debts in this Figure indicate that the ability of the private sectors in developing countries to borrow abroad has increased substantially, and the proportion of external liabilities taken up by securitised debts has also increased. As documented by Akyüz (2012), in many emerging economies foreign investors have become primary holders of capital and debt securities, as a result of the increasing portfolio flows targeting equities and local currency debt. This is also a result of the rise of corporations in

emerging countries borrowing externally.

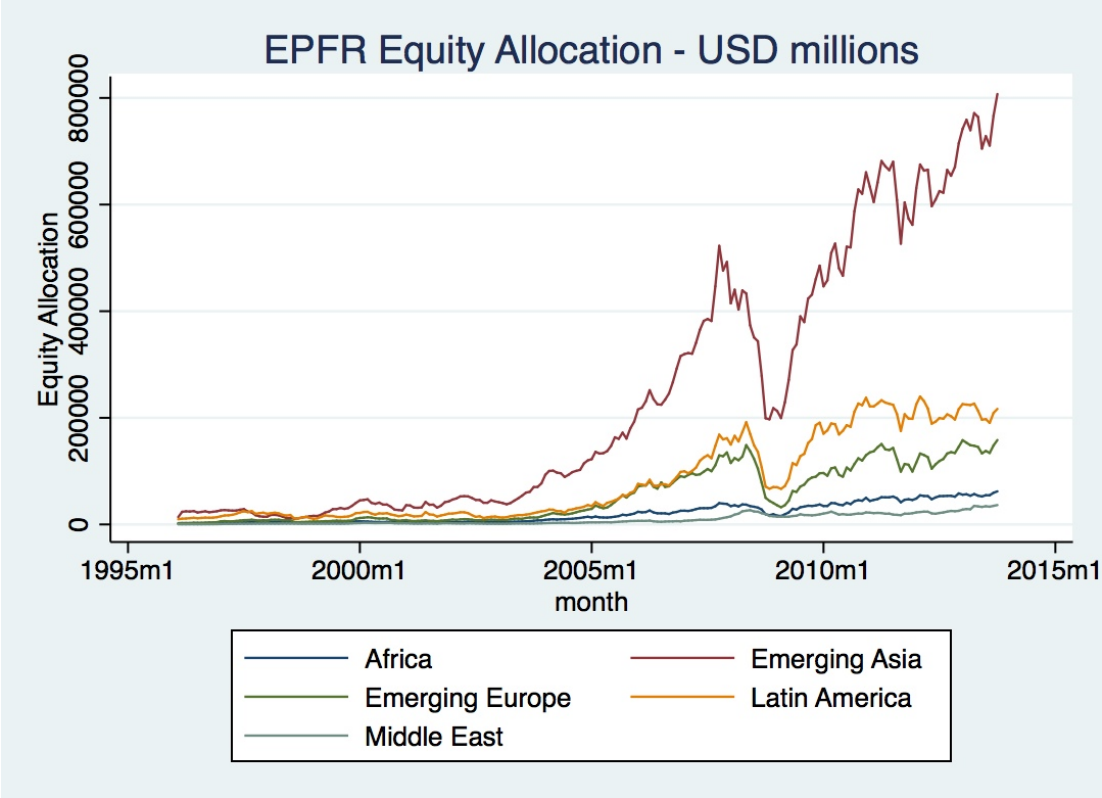
Clear evidence of such increase in participation by foreign financial investors can be seen through the Emerging Portfolio Fund Research database, which collects data from mutual funds. This database shows how foreign investors' holdings of emerging markets equities and bonds have increased rapidly over the past decade (Figure 1.3.7). This confirms findings in figure 9 which indicates a growing composition of external debt being made up of private sector and public sector bonds. Equity holdings increased earlier, but bonds holdings have been catching up very quickly, especially after 2008 (Figure 1.3.8). As a result, the magnitude of the flows representing purchases and sales of securities has similarly increased (Figure 1.3.9 and 1.3.10).

Figure 1.3.7 Emerging Portfolio Fund Research Bond Allocation



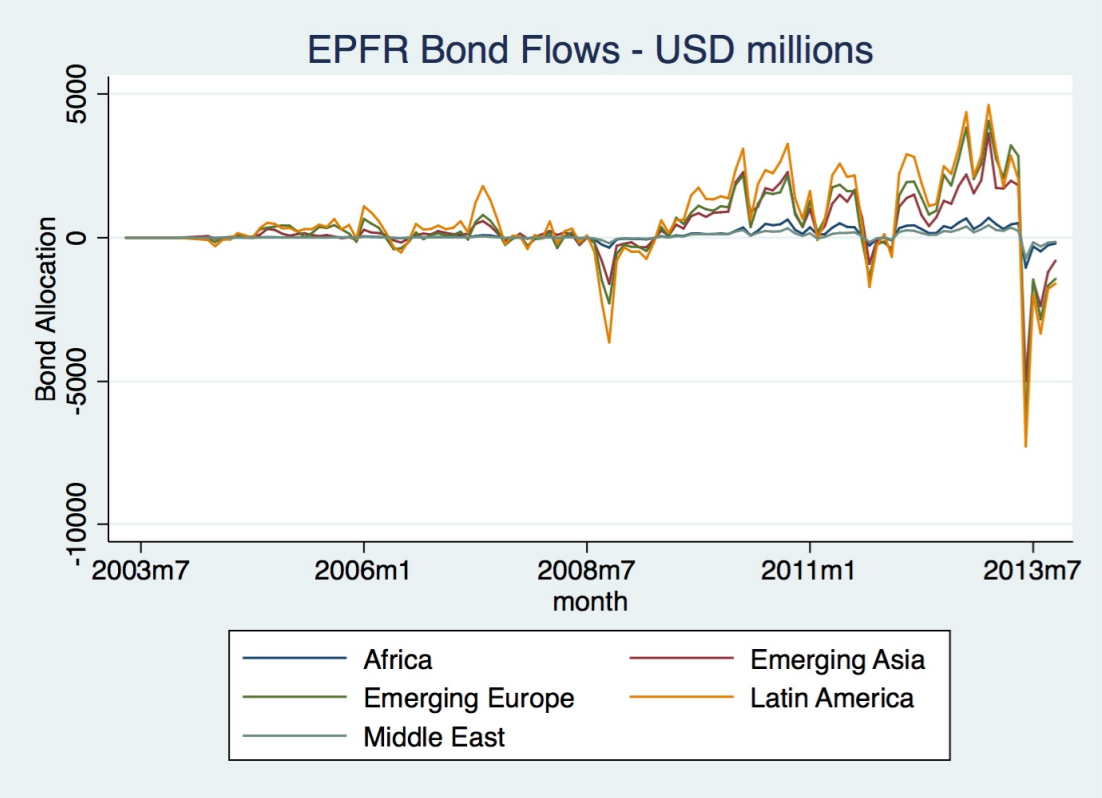
Source: Emerging Portfolio Fund Research database

Figure 1.3.8.



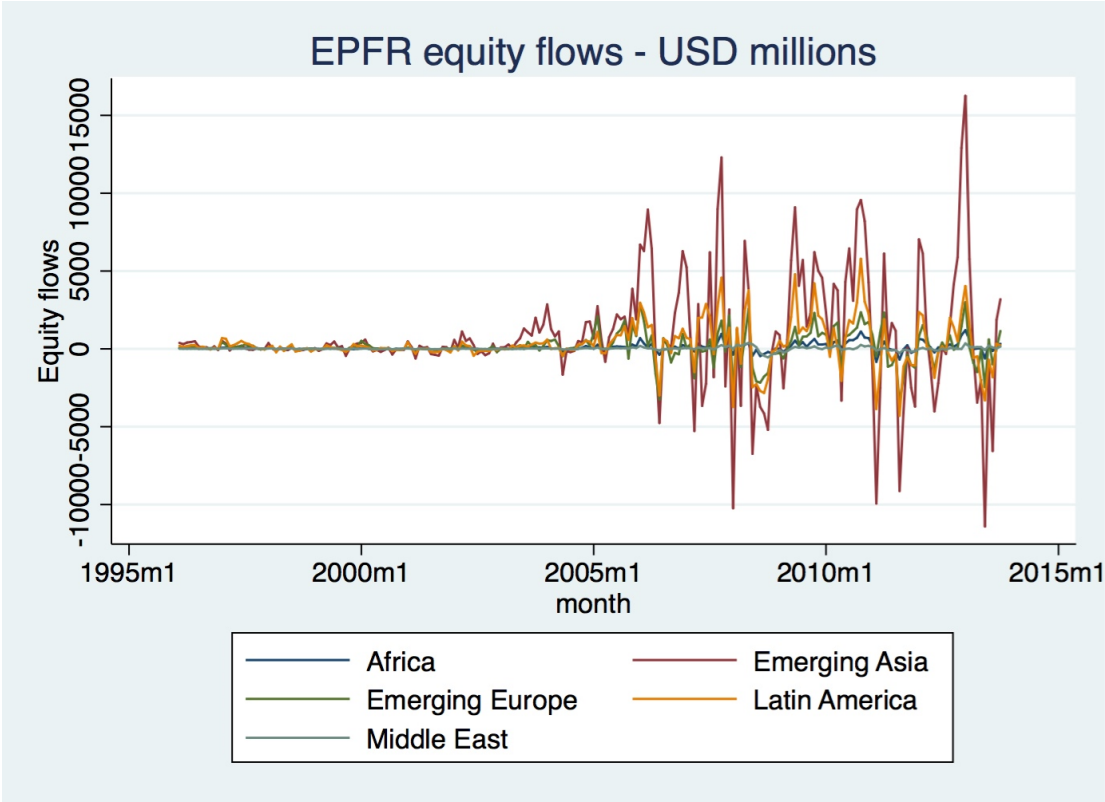
Source: Emerging Portfolio Fund Research database

Figure 1.3.9.



Source: Emerging Portfolio Fund Research database

Figure 1.3.10.



Source: Author's calculation based on the EPFR database

These figures show an increasing involvement of the private sector in the developing countries' external debt. The public sector, previously reliant almost entirely on official credit, has become able to access private debt markets. This trend is the product of the integration of many developing countries into the global financial system. That integration followed the writing down or refinancing of public external debt in those countries, through support from the International Monetary, and the Highly Indebted Poor Countries initiative. More recently, international financial investors, subject to the low-interest rate environment in Japan, North America and Europe, have been attracted by the apparently substantially improved fundamentals of many developing countries, in a 'search for yield' for their portfolio investments.[20] Overall then, the recent changes in the composition of the developing

[20] It is important to note as well that official development policy has itself become more supportive of the private sector. As documented in Bonizzi et al., (2015), there has been a shift in the official development policy consensus towards the promotion of private sector. Indeed, a substantial part of official flows from advanced countries goes to support private sector initiatives, including the financial sector, rather than humanitarian purposes. Furthermore, official flows themselves are increasingly being augmented with private funds through the process of 'blending', whereby private financial institutions complement the official aid budgets with guarantees being provided by the borrowers and/or the donors. This policy consensus helps explain the

countries' external debt indicate an increasing involvement of private sector institutions, both as borrowers and lenders.

1.4 Financial globalisation and international monetary cycle

The growing participation of these emerging and developing countries into the global financial market expose the international monetary cycle that determines the liquidity of international capital markets and hence the potential for private and public sector external indebtedness, as well as the potential for refinancing along the yield curve. This cycle is driven by the monetary policy of central banks in countries that are international financial centres or intermediaries, principally the United States of America, but also Great Britain, Switzerland and the European Monetary Union, and to some extent also Tokyo and Singapore.

The monetary cycle determines the liquidity of capital markets in those financial centres, in the sense that changes in central bank interest rates alters the composition of financing in those centres, because the relative cost of different types of financing is changed, and also in the sense that open market operations, such as the recent 'quantitative easing', exchange central banks reserves for long-term securities, thereby making markets for those securities more liquid. In the case of international financial centres, the liquidity of their capital markets necessarily includes the liquidity of international markets.

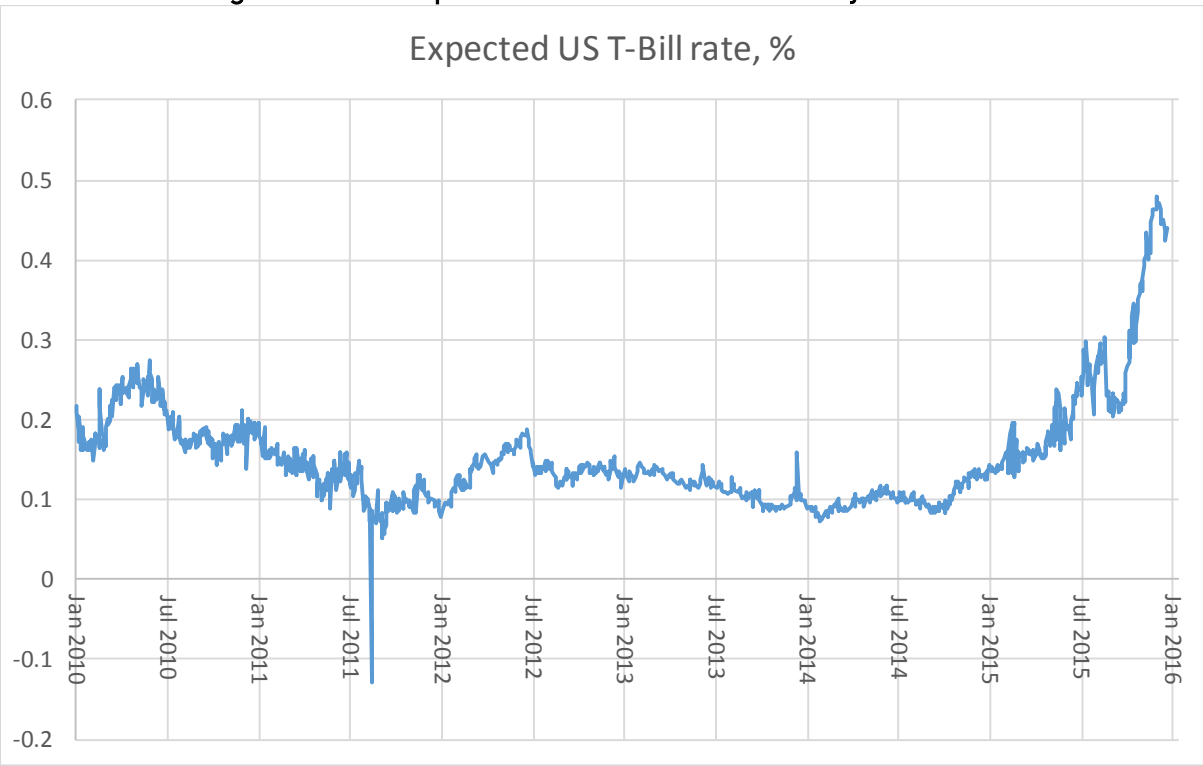
There is considerable evidence of a major shift in perceptions of risk in international capital markets, driven by expected changes in US monetary policy (Shin, 2012; Rey, 2013). Whenever US monetary policy becomes highly expansionary, with low interest rates and ample provision of liquidity, investors and lenders become more risk-seeking, reducing global risk-premia and spreads. Conversely, any prospect of monetary tightening tends to increase risk-premia, as investors become more risk-averse and invest in safer assets. With their emerging integration into global financial markets, the emerging and developing countries' bond yields may indeed by affected by these processes.

For example, Figure 1.4.1 shows the expected 3-months US Treasury Bill rates, which can be seen as an indication of future monetary policy actions, as T-Bill rates tend to follow

expansion of private sector in some of these regions, for example, SSA.

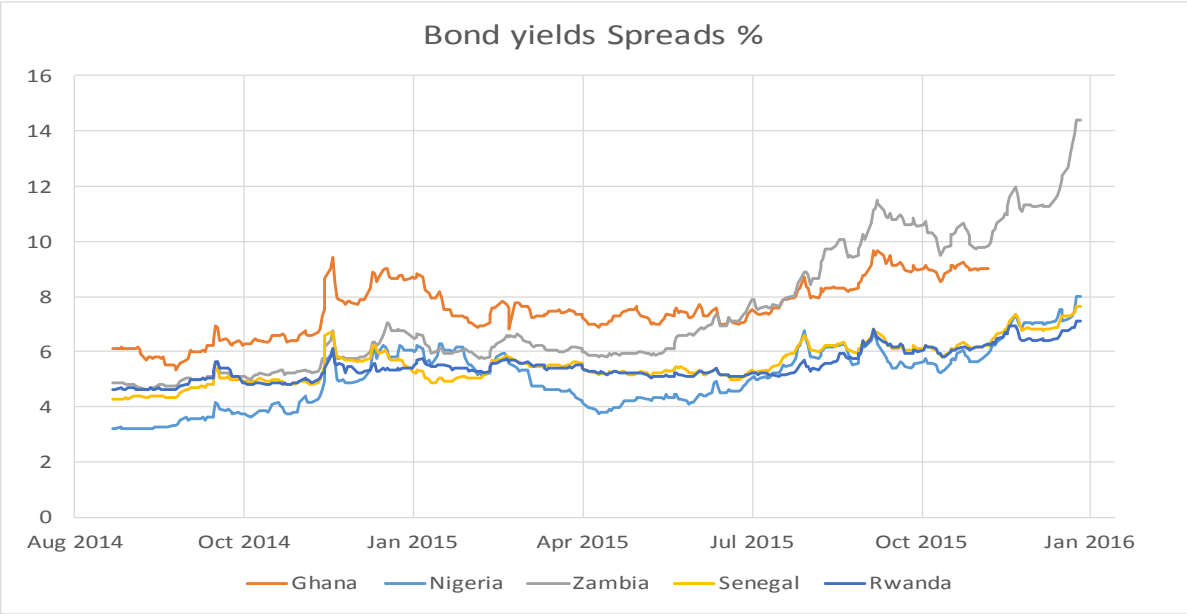
quite closely the FED's policy targets. It is very clear that international investors have been expecting a rise in interest rates throughout 2015, and therefore anticipating a monetary policy tightening, which in fact occurred in December. This may have affected Sub-Saharan African countries' bond yields, and contributed to explain why many SSA countries' spreads have been increasing in the same period (Figure 1.4.2).

Figure 1.4.1. Expected 3-month US Treasury Bill Rate



Source: Bloomberg.

Figure 1.4.2. Spreads on Bond Yields

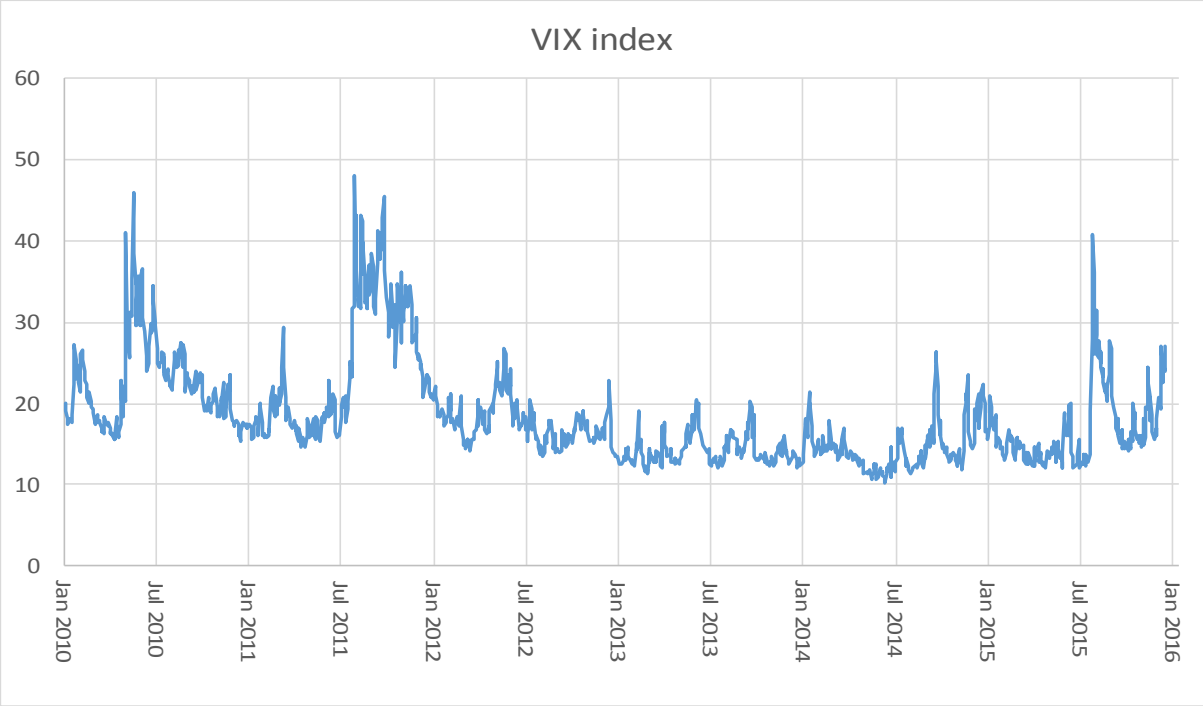


Source: Author's calculation based on Bloomberg

Note: Yield spreads are calculated as the difference between the yields on foreign currency bonds, based on indices for each of the countries, and the yields on Bloomberg bond index for global developed countries debt.

Besides, a frequently used indicator of investors' confidence is the Volatility-Index (VIX), shown in figure 1.4.3, which measures the implied volatility that investors expect from the S&P 500 index. Higher levels mean high expected volatility and therefore lower investors' risk appetite. Spikes in the VIX index can be seen in May 2010, the summer of August 2011 and August 2015, all notoriously turbulent periods for financial markets. Comparing this with Figures 1.3.8 and 1.3.9, bond flows and allocation, it can be clearly seen that during these periods inflows were much lower (in May 2010) or negative (during Summer 2011). Taking SSA as an example again, it can also be seen that spreads soared in second half of 2015.

Figure 1.4.3. Implied Volatility



Source: Bloomberg

Financial integration and the increase presence of private investors and private capital in emerging and developing countries make their financing conditions more closely dependent on global financial market trends. This in turn shows two interesting aspects. First, it confirms the limitation of the capital account framework explain capital inflows and outflows to these countries. Second, while the access of these countries to more diverse sources of credit can be potentially positive for external debt sustainability, it also adds the vulnerability of global financial factors to the traditional balance of payment concern. Therefore, the integration of these markets into the global financial system needs therefore careful scrutiny to ensure that it does not create more instability than benefits.

The integration of the emerging and developing economies from the perspective of increasing of cross border assets and liabilities, and consequently, the increasing presence of private international investors should take the governments and multilateral agencies to look beyond the traditional forms of integration and instability and fluctuation crisis-mechanisms. The international monetary cycle is one on aspect of it, which involves not only the US monetary policy, including among other things strengthening of the US dollar, the so-

called quantitative easing and so on, but also the Bank of England and the European Central Bank monetary policies, for example. Other aspect is the fact that interest rates on private external debt are determined in global markets, which clearly applies to bond markets in general. This indicates that private debt is more directly exposed to fluctuations to global market changes, so attention has to be given to debts that float with markets rates such as the LIBOR, for example. Capital controls also affect the direction of flows in the international capital market both when capital controls seek to exclude such flows, and when such flows are allowed. An analysis of the capital flows within emerging and developing economies considering some of these aspects is beyond the scope if this paper.

The participation of the European Union in the international monetary cycle has been modest. The largest financial centre in the Union, the United Kingdom, is a major participant in global financial markets. But the institutions dominating UK markets have been largely US-based and, since the deregulation of the capital markets in the 1980s, UK interest rates and exchange rates tend to follow trends set in the US (see Shabani et al, 2014). Capital markets in continental Europe have been depressed by the government debt crises afflicting governments in the EU, and liquidity provision by the European Central Bank has been focused in alleviating liquidity shortages in banks, rather than buoying up capital markets and thereby facilitating lending and bond issuance outside the European Union.[21]

[21] The open capital account between the European Union and the United States makes it difficult to distinguish any liquidity effect of the operations of the European Central Bank from the international effects of quantitative easing by the Federal Reserve. While the Federal Reserve has bought some $1.75 trillion of securities, the European Central Bank's holdings of assets (i.e., net purchases) have risen by only some €1.4 billion since the financial crisis erupted in 2008 (see https://research.stlouisfed.org/fred2/series/ECBASSETS).

2. The EU and Developing Economies

2.1 Cross capital flows activities: EU and its Aid policy

The increasing involvement of the private sector in developing and emerging countries' external debt, and the fact that the private sector in these countries has expanded its international borrowing mostly through access to international banks and corporate bond markets is as showed above the result of the growing integration of developing and emerging countries into the global financial system. But this trend is also the product of official development policy becoming more supportive of the private sector. The EU Aid provision has followed the global debate on aid provision and its links to the global trajectory that emphasizes the need to innovate financial instruments and techniques in order to pool public and private funds together. In this light, The Aid policy of the European Union has placed financial deepening at the heart of its development policy. As a result, this Aid policy has been intertwined with the process of financialisation in two main ways. Firstly, a non-negligible proportion of Aid flows are linked to the promotion of private sector, for-profit activities, which very often include the development of the financial sector in developing countries. Secondly, the provision of Aid itself has become closely linked to the financial sector through the process of "blending", which effectively increases the Aid budget by means of leveraging.

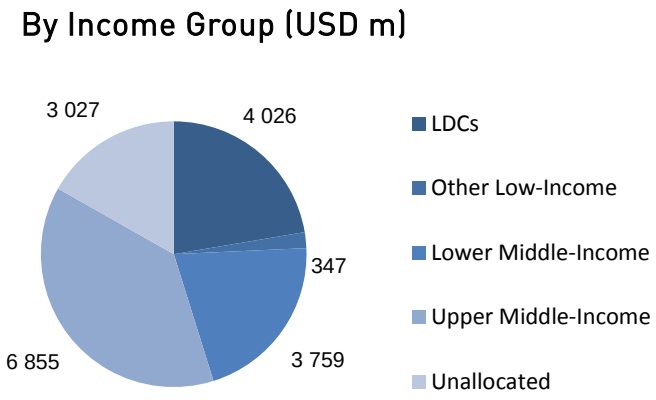
The EU institutions and the member states collectively spent €55.2 billion euros in aid (ODA) in 2012, making the EU one of the most important sources of development aid globally (DEVCO, 2013).[22] A third of EU institutions' aid allocation is channelled to just five countries, all in the MENA and European regions. The five top recipients of EU institutions' aid are (USD million): Turkey (2 967), Serbia (998), Tunisia (541), Morocco (463), Egypt (455).[23] A key

[22] The EU Aid expenditure is cyclical, and there has been a notable decrease in aid spending since the crisis in Europe deepened as the EU States decreased their aid expenditure during the crisis, with the ODA/GNI ratio declining from 0.44% in 2010 to 0.39% for the 28 EU member states (European Commission, 2013a). Member states have pledged to allocate 0.7% of the GNI in development aid, a promise however that only few manage to keep. Nevertheless, the EU institutions' ODA, which is partially funded from resources independently of the member state's contributions, actually increased between 2011 and 2012 and is projected to keep increasing.

[23] Source: OECD, DAC, Aid statistics

recipient of EU aid is clearly the Turkish financial sector, which in 2012 received 17% of EU aid funds. Over half of aid is directed to middle income countries, which shows that, although recent EU policy commitments have taken note that more aid should go to low income countries (figure 52), as currently only a quarter goes to least developed countries, the issue of the consequences of the financial sector being an increasingly privileged recipient of aid has not been adequately addressed.

Figure 2.1. Aid distribution – by income group



Source: OECD, DAC, Aid statistics

Looking closely at the OECD DAC aid statistics database, the indication of the importance of the financial sector as an aid recipient for the whole EU institutions and member States can been seen when considering that the Banking and financial sector gets about 2 to 4% of total ODA by 2012. Although this may appear a modest proportion, it account for the third important beneficiary sector as part the ODA given for the economic development, after energy and agriculture, much higher than the support to the industrial sector (Table 2.2).

Table 2.2. Aid distribution by sector

DAC EU Members, total ODA	2006	2007	2008	2009	2010	2011	2012

I. Social Infrastructure & Services	30.80%	37.70%	38.22%	41.22%	34.96%	37.90%	40.67%
II.1. Transport & Storage	2.33%	2.48%	4.14%	2.94%	2.67%	2.14%	3.90%
II.2. Communications	0.25%	0.23%	0.20%	0.43%	0.41%	0.36%	0.22%
II.3. Energy	1.93%	1.87%	3.76%	3.88%	6.66%	4.84%	7.37%
II.4. Banking & Financial Services	2.30%	4.39%	4.06%	4.62%	2.36%	3.50%	3.44%
II.5. Business & Other Services	0.72%	1.71%	1.06%	1.17%	1.52%	2.30%	0.90%
III.1 Agriculture, Forestry, Fishing	2.30%	3.62%	3.14%	4.27%	4.47%	4.02%	4.76%
III.2 Industry, Mining, Construction	0.56%	0.81%	1.17%	1.13%	1.84%	1.84%	1.21%

Source: OECD DAC aid statistics database

A further breakdown reveals interesting additional details. The ODA provision to banking and financial service has increased among the DAC-EU member since 2002. The sectorial allocation of ODA to the financial sector for the member states covers between 3 to 5% of the aid budgets in the years between 2008 and 2012. As a mean of comparison this is more or less the same proportion given as ODA for Healthcare or Water and Sanitation (Figures 2.3 and 2.4).

Figure 2.3. ODA to banking and financial service as proportion of total ODA

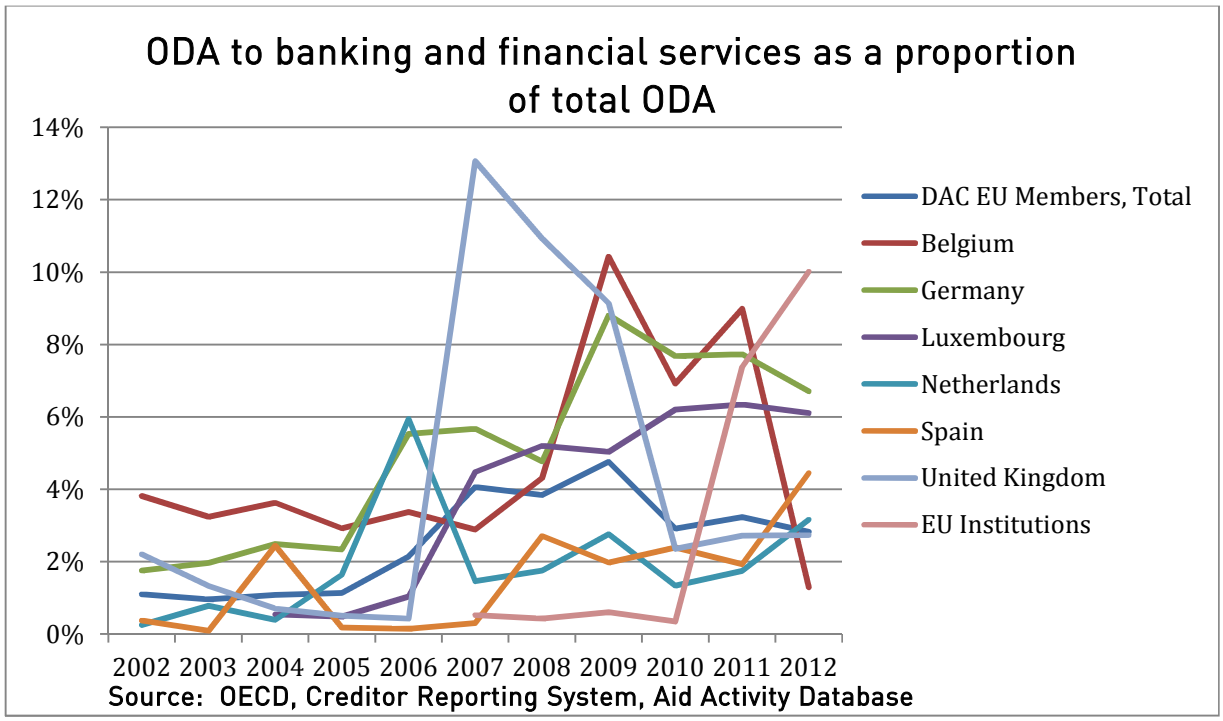


Figure 2.4. ODA to banking and financial service as proportion of total ODA – comparison by sectors

DAC-EU Members, Total	2008	2009	2010	2011	2012
Health	5%	5%	5%	4%	5%
Water and Sanitation	4%	5%	4%	4%	4%
Banking and Financial services	4%	5%	3%	3%	3%
Business and Other services	1%	1%	1%	2%	1%

Source: OECD: Creditor Reporting System, Aid Activity Database

Besides, the proportion of ODA directly given by the EU institutions to Banking and Financial services, although small until 2008 (0%), has increased considerably in recent years reaching a high figure of 10% in 2012. This is more than double the size taken Water and Sanitation aid and nearly five times the amount given for Healthcare (Table 2.5).

Table 2.5 Proportion of ODA directly given by the EU institutions to Banking and Financial services

EU Institutions	2008	2009	2010	2011	2012
Health	4%	4%	3%	3%	2%
Water and Sanitation	4%	4%	4%	4%	4%
Banking and Financial services	0%	1%	0%	7%	10%
Business and Other services	1%	1%	1%	1%	0%

Source: OECD: Creditor Reporting System, Aid Activity Database

Within the ODA to the Banking and Financial services, according to the OECD Creditor Reporting System Aid Activity Database, the biggest and increasing proportion goes directly to financial intermediaries. From 2004 to 2012 aid money to formal financial intermediaries has increased proportionately, from about half to 94% (Table 2.6). Another trend with regards the amounts of aid channeled to the financial sector is the difference between the amount committed and actually disbursed. The trend of the past seven years has been for the amounts disbursed to the financial sector to far exceed the amounts that were originally committed for the year (Table 2.7). Finally, a noticeable feature of the funds spent in the name of development that end up being channeled to the financial sector are the funds of Other Official Flows (OOF), i.e. the funds that do not fulfill the ODA criteria but are official development finance. This is a trend true of all development finance institutions, as indicated above (Table 2.8).

Table 2.6. Breakdown of ODA to financial sector

	2004	2005	2006	2007	2008	2009	2010	2011	2012
Financial policy and admin management	12%	8%	20%	9%	6%	10%	9%	2%	3%
Monetary institutions	7%	24%	0%	1%	1%	0%	1%	4%	1%
Formal sector financial intermediaries	46%	52%	72%	73%	83%	74%	72%	87%	94%
Informal / Semi formal FIs	33%	15%	7%	16%	10%	15%	17%	5%	2%
Education/ Training in Banking & financial services	3%	1%	2%	2%	1%	1%	2%	1%	0%

Source: OECD: Creditor Reporting System, Aid Activity Database

Table 2.7. Committed aid channeled to the financial sector *versus* the amount actually disbursed

Banking and financial sector			
eur million	Committed	Disbursed	Difference %
2007	35.05	54.52	56%
2008	13.63	55.27	306%
2009	22.67	27.2	20%
2010	1.17	33.15	2733%
2011	3.27	39.46	1107%
2012	32	25.47	-20%
2013	35	12.78	-63%

Source: Annual reports on EU's Development and external assistance policies and their implementation, various years.

Table 2.8.

OOF flows going to Banking and Financial Services as a proportion of total OOF flows											
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
All Donors Total	13%	14%	12%	13%	9%	10%	3%	16%	13%	11%	10%
Multilateral, Total	13%	14%	12%	13%	9%	10%	3%	16%	13%	11%	10%
AfDB	52%	73%	35%	23%	1%	37%	1%	49%	16%	23%	16%
AsDB									7%	12%	10%
EBRD								29%	36%	35%	33%
IBRD	11%	8%	10%	12%	9%	6%	3%	9%	13%	3%	3%
IDB								14%	9%	9%	9%
OFID (OPEC fund for Int Dev)								33%	23%	30%	34%

Source: OECD, Creditor Reporting System, Aid Activity Database (CRS)

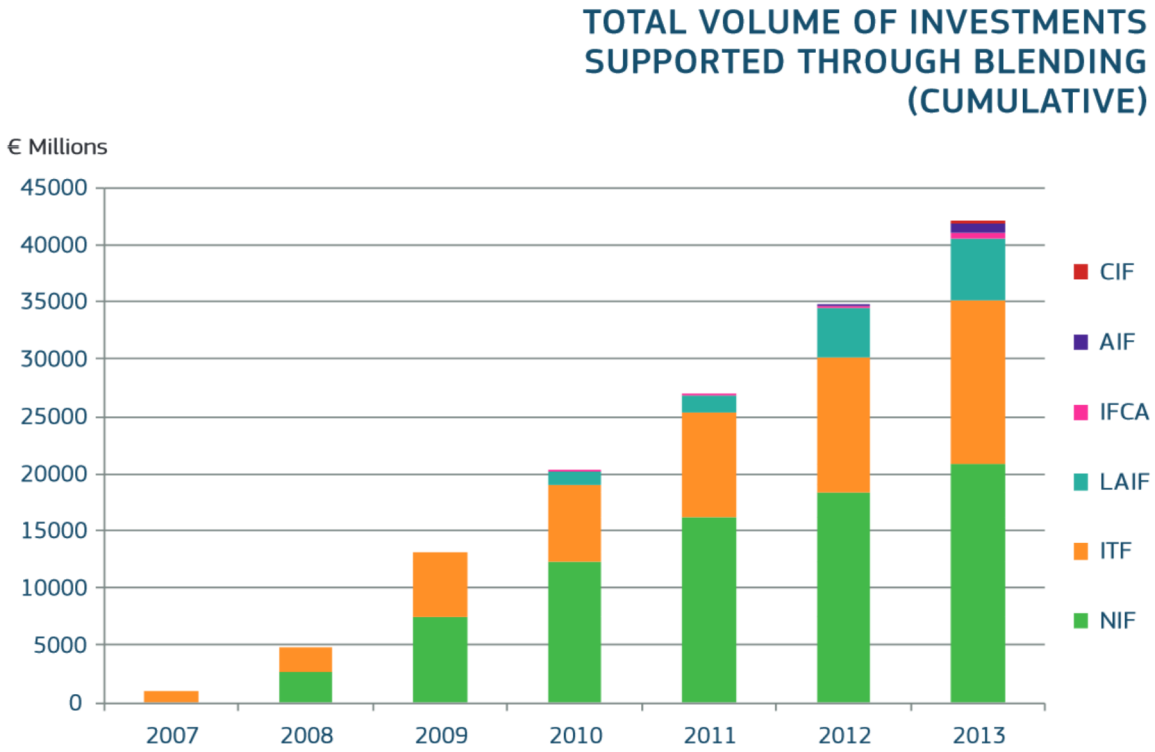
Thus, official flows to the financial sector represent an important and critical component of EU aid. While not too prominent as a proportion of total aid for member countries, they represent nonetheless one of the top three recipient sectors together with the agricultural and energy sectors, dwarfing the aid the whole industrial sector. The proportion for EU institutions alone is at a staggering 10% of their total aid. A growing proportion is also going to financial intermediaries directly. This reveals the crucial role given by the EU to the development of the financial sector as an engine of economic development. However, concerns have been raised about the effectiveness of the financial sector, and certainly the proportion of support given to the financial sector as opposed to that given to the industrial sector raises concerns. Finally, this only covers the 'traditional' ODA, and as the showed below, the increasing reliance on blending mechanisms to increase the aid budgets, may well increase the actual proportion of financial sector support.

It is important to highlight as well that a key element in recent EU policy practice is the emphasis on using the development finance that is available in 'innovative and effective ways'. It has been argued that "innovative modalities of delivering finance can increase effectiveness and should be scaled up. Blending of grants with loans and equity, as well as

guarantee and risk-sharing mechanisms can catalyse private and public investments, and the EU is actively pursuing this" (European Commission, 2013c). Essentially, the public ODA funds has been used to leverage private funds and on developing broader types of public-private partnerships.

To scale up the blending mechanisms, the EU Platform for blending in External Cooperation was launched in December 2012. At the core of blending is the use of the grant element in EU funding as a magnet to attract additional financing. The grant element can be used in many ways: about a third EU blended grants are used as direct grants, interest rate subsidies and technical assistance, and a small share as risk capital operations and/ or guarantees and insurance premia (Planas, 2012). The total volume of investments supported through blending has increased dramatically since 2008, and even regional blending facilities were set up through the 2007-2013 MFF: EU-Africa Infrastructure Trust Fund (ITF) 2007, Neighbourhood Investment Facility (NIF) 2008, Latin America Investment Facility (LAIF) 2010, Investment Facility for Central Asia (IFCA) 2010, Caribbean Investment Facility (CIF) planned for 2012, Asian Investment Facility (AIF) starts operation in 2012, Investment Facility for the Pacific (IFP) planned for 2012 (Planas, 2012) (figure 60). The EU states that in the past seven years €1.6 billion of EU grants have been used to leverage in approximately €16 billion of loans from European finance institutions and regional development banks, in approximately 200 blended projects. Approximately two thirds of the EU grants that are allocated to blending projects end up in energy, and transport infrastructure projects (European Commission 2014b).

Figure 2.9.



Source: European Commission (2014b)

The EIB also manages two blending mechanisms, through the Investment Facility that is composed of the two financing windows (one for African, Caribbean and Pacific Countries and one for Overseas Countries and Territories) (see Figure 2.9). In 2012 for example 43% of EIB lending went to the financial sector in ACP countries: "there is a relentless emphasis given on ways of 'leveraging private sector activity and resources' as a means to provide public goods" (Romero, 2013).

The narrative within the recent policy documents to bring the private sector into the heart of development finance lucidly reveals the theoretical understandings of the policy proposals. Furthermore, it potentially serves as a means to deflect from the decreasing amounts of official funds spent on aid, and this bolsters the drive to bring the private sector in. Nevertheless, whether referring to Overseas development Assistance (ODA) or Other Official Flows (OOF) and their use in leveraging in private sector funds a few methodological points are raised. Contingent liabilities are not recorded within the ODA and OOF data and there is an issue of whether the leveraged private sector funds could potentially constitute contingent liabilities for the EU. Furthermore, there does not appear to be sufficient

evaluation of the liabilities that could be created for developing countries themselves. It is frequently observed in both developing and developed countries that the liabilities of the private sector are taken on by the state when they cannot be met, and this is particularly true of the banking sector's liabilities. Therefore there are significant debt implications for developing countries arising from the increased loans to the financial sector, both in itself and to the degree that this is enhanced by the use of blending mechanisms. These do not appear to be significantly addressed by the EU development policy.

Another issue is that of assessing the degree of leverage and thus potential development finance arising from assuming or calculating a multiplier. It is not clear what the multiplier is, nor whether it is realistic. For example, although the EU provides clear data on the amount of EU grants channeled into blending, it is not equally as transparent on the leveraged funds' size or source. A recent example regarding the EU Commission's plan to establish a European Fund for Strategic Investment (EFSI) that estimates that €21 billion of official funds will leverage in total funds of €315 billion over three years, does not however provide adequate evidence that this will be feasible (European Commission, 2014c). It also remains unclear how financial institutions' profit maximisation and risk management will coincide with development policy under an ODA criteria, and how this will be maintain effective electoral oversight (European Parliament, 2012). Although the European Parliament encourages and recognises that the development of innovative financial mechanisms are crucial to the future of development finance, it also expresses a concern.[24]

The main arguments used by the EU to support its use is that for recipient governments in developing countries blending provides a sustainable source of additional financing, and that the main benefit for the private financiers who are attracted in is that the 'risks associated with investing in new markets and sectors' are mitigated. The benefits according to the EU are not only financial but also that blending can be used to leverage policy to support 'reforms in line with EU policies' (European Commission 2013d). The centrality of using risk-bearing mechanisms as part of blending is emphasised and thus "the

[24] See European Parliament (2012)

Commission carefully considers potential risk to ensure that the EU grant element addresses market failures and channels private financing towards investments that contribute to poverty reduction, while avoiding market distortion." How it will do this is unclear.

3. A paradigm shift in International Finance

The elevated importance of financial markets in the globalized economy and the gradual integration of developing and emerging economies has paved the way for a New International Financial Architecture (NIFA). Within this framework, the traditional players, that is national governments, multilateral agencies (IMF, WTO) and multilateral government bodies (like the G20) are faced with a *new regionalism* described as the increased cooperation between governments in particular regions in order to resolve economic, social and political difficulties that affect more than one sovereigns. In this context, the EU will face new, diverse obligations vis-a-vis its member states in the core and the periphery as well as with the developing countries and emerging economies including the BRICS countries. In this section we elaborate on the rising forms of financial cooperation between the EU and the developing world. More specifically, the role of emerging markets as potential sources of finance for the EU is examined taking into consideration different financial channels, namely Sovereign Wealth Funds, foreign exchange reserves, Foreign Direct Investment, Hedge Funds and Venture Capital. Light is cast on the ways that the EU could benefit from these actions as well as the implications for the developing economies.

3.1. Sovereign Wealth Funds

3.1.1 Definition and scope of SWFs

Another aspect of the new developments in EU finances and the relationships between the Union and the rest of the world is the potential role of Sovereign Wealth Funds (SWF) for the financing needs of member states. This is of particular importance for the indebted European nations in the periphery which face significant bottlenecks regarding their access to finance. In light of this development, there is discussion on the capacity of SWFs to provide

the necessary liquidity through sovereign bond purchases among other actions as well as the economic and political motivation behind such decisions.

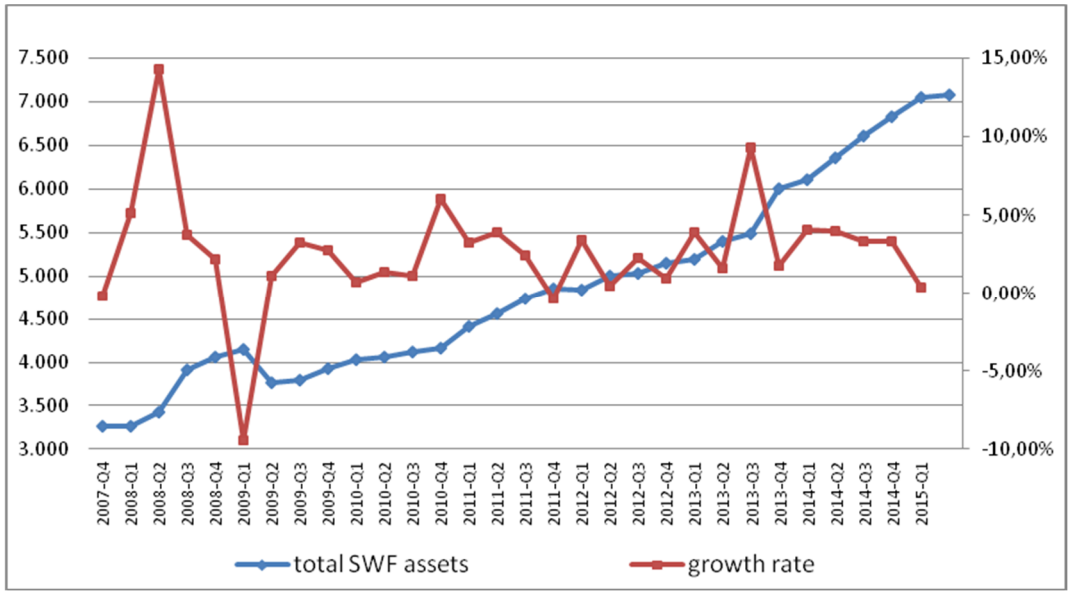
The last fifteen years have marked a swift increase in the number of Sovereign Wealth Funds and the value of their total holdings. Despite the stabilizing role that they played in the wake of the financial crisis in 2008 (Cohen 2008), there is still much room for debate as far as their position in the globalized financial system is concerned. Drezner (2008) highlights the potential destabilizing effects of SWF participation should a new wave of financial distress emerge in the near future. As we shall see the majority of SWFs are located outside the western economies giving an early but important intuition of the economic order to come. This spurs controversy over the economic and political implications that these institutions will have for the European financing system. To be more precise, the question raised is whether the Sovereign Wealth Funds can prove to be a lender of last resort for European countries with financial woes. That said, we focus on the degree to which this is possible given the SWFs' financial stance and also on the degree to which they are willing to undertake this role. Finally, the political and geopolitical repercussions of such actions need to be examined thoroughly.

A uniform formal definition of Sovereign Wealth Funds does not exist in the literature, nevertheless the International Working Group on Sovereign Wealth Funds (IWGSWF 2008) gives a balanced definition according to which Sovereign Wealth Funds are " special purpose investment funds or arrangements, owned by the general government". The European Commission (2008) defines them as " state-owned vehicles, which manage a diversified portfolio of domestic and international financial assets". The IMF focuses on the investment behavior of these entities and restricts their behavior to holding foreign assets for long-term purposes. In this study a more broad definition of SWF is preferred to capture activities by entities with a wide range of investment positions as well as different sources of funds that range from export earnings (predominantly by oil and gas exports) to current account and fiscal surpluses.

The first issue under consideration is the size of the SWFs, that is the value of their total assets. As can be seen at the figure below total assets have been rising robustly over

the last 8 years with positive growth in all but two quarters. Their cumulative size is measured (March 2015) at 7,084 billion dollars more than double the value observed in March 2008. The dynamics of the size of SWFs that are evident in the robust growth rates make them a potential key player in the global financial system despite the fact that, currently, their size is small compared to total financial assets in the global economy.

Figure 3.1.1 Total Assets of Sovereign Wealth Funds



Source: SWF Institute

The latest projections, although subject to possible error (Drezner, 2008, Cohen, 2008), imply that SWF total assets will have exceeded 15 trillion dollars by 2021 and almost 33 trillion by 2028. In the light of such a process, it is definite that the weight of SWFs in international finance will increase substantially. A second characteristic worth examining is the origin of the most important funds. Table 3.1.2 clearly points out that, with the exception

of the Norwegian Government Pension Fund, the largest SWFs originate outside Western Europe and North America. The data reveal that most of these entities are located in oil-exporting Middle Eastern countries or emerging economies in East and Southeast Asia with their funds stemming from vast current account surpluses. The table indicates a certain balance between the two types of Funds in terms of their asset sources. The concentration of assets, however, is rather striking with the three largest funds accounting for 1/3 of total assets, a ratio that exceeds 50% if we add the two Chinese SWFs in fourth and fifth position. The Funds presented at the table hold 90% of SWFs globally.

Table 3.1.2: Sovereign Wealth Funds' ranking by total assets held

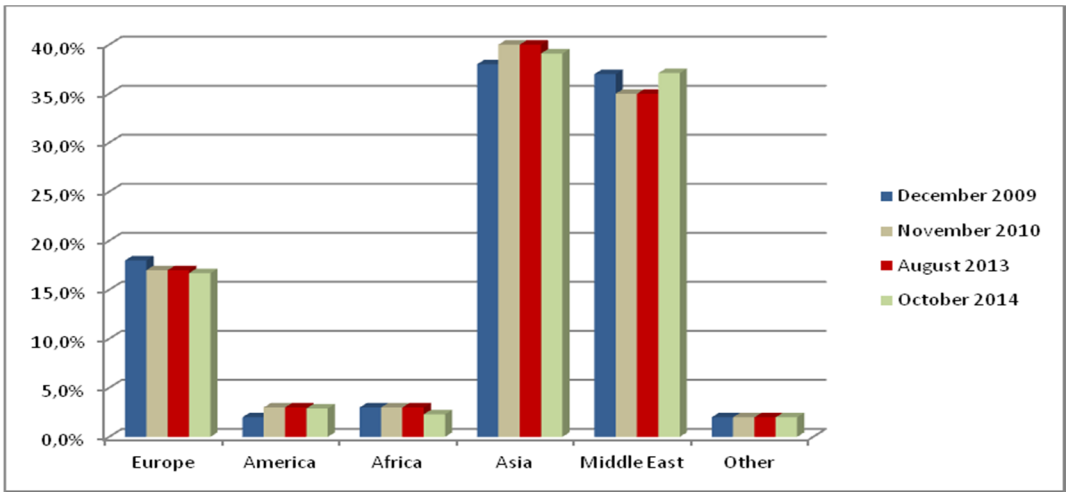
ranking	Sovereign Wealth Fund	Country	Inception	Origin	Assets (in $ billion)	Assets (% of total SWF)	Wealth per capita ($)
1	Government Pension Fund - Global	Norway	1990	oil	863	12,18%	176.482

2	Abu Dhabi Investment Authority	United Arab Emirates - Abu Dhabi	1976	oil	773	10,91%	839.305
3	SAMA Foreign Holdings	Saudi Arabia	n/a	oil	757,2	10,69%	26.110
4	China Investment Corporation	China	2007	non-commodity	652,7	9,21%	484
5	SAFE Investment Company	China	1997	non-commodity	567,9	8,02%	420
6	Kuwait Investment Authority	Kuwait	1953	oil	548	7,74%	162.611
7	Hong-Kong Monetary Authority Investment Portfolio	Hong-Kong (China)	1993	non-commodity	400,2	5,65%	55.738
8	Government of Singapore Investment Corporation	Singapore	1981	non-commodity	320	4,52%	60.377
9	Qatar Investment Authority	Qatar	2005	oil & gas	256	3,61%	134.737
10	National Social Security Fund	China	2000	non-commodity	240	3,39%	177
11	Temasek Holdings	Singapore	1974	non-commodity	177	2,50%	33.396
12	Australian Future Fund	Australia	2006	non-commodity	95	1,34%	4.127
13	Abu Dhabi Investment Council	United Arab Emirates - Abu Dhabi	2007	oil	90	1,27%	97.720
14	Reserve Fund	Russia	2008	oil	88,9	1,25%	620
15	Korea Investment Corporation	South Korea	2005	non-commodity	84,7	1,20%	1.440
16	National Welfare Fund	Russia	2008	oil	79,9	1,13%	558
17	Samruk-Kazyna JSC	Kazakhstan	2000	oil	77,5	1,09%	4.330
18	Revenue Regulation Fund	Algeria	2000	oil & gas	77,2	1,09%	2.027
19	Kazakhstan National Fund	Kazakhstan	2000	oil	77	1,09%	4.302
20	Investment Corporation of Dubai	United Arab Emirates - Dubai	2006	oil	70	0,99%	33.238
				total assets (top-20)	6.295,2	88,87%	
				total assets (top-10)	5.378,0	75,92%	
				total assets (all SWF)	7.084,0		

Source: SWF Institute

The concentration of assets, however, is rather striking with the three largest funds accounting for 1/3 of total assets, a ratio that exceeds 50% if we add the two Chinese SWFs in fourth and fifth position. The Funds represented in the table constitute 90% of SWFs globally. The regional allocation of SWFs is depicted in Figure 3.1.3 below shows the importance of Asia and the Middle East. Furthermore, it is noteworthy that the European share has decline from 18% to 16,7% with the Norwegian pension fund representing roughly between 2/3 and 3/4 of the European assets.

Figure 3.1.3 SWF Total Assets by Region



Source: SWF Institute

The data summarised illustrate the role and operation of SWFs. The large participation of Russia and China with such entities raises questions on the degree of state intervention in financial markets and the lack of democratic institutions in some origin countries. Nevertheless, the concern over SWFs should not be entirely attributed to these two factors given the fact that state intervention could be welcome in the event of a financial crisis with the characteristics of 2008-09. Moreover, traditional funds from the Middle East do not operate within a fully democratic regime and there is no economic reason to believe that an autocratic government would allocate its financial resources in a more destabilizing fashion. Weiss (2008) shows that there is no significant difference in investment behavior between SWFs and private investors. Nevertheless, the nature and motivation of SWFs should be closely examined emphasizing on political factors as well.

Before critically evaluating the areas of concern outlined above, we move to see the refinancing needs of European nations and to what extent the SWFs could be of assistance. Our analysis is based on four assumptions. Firstly, refinancing needs are confined to government debt securities based on their maturity schedule and not general financing needs. EU's Fiscal Compact (2013) makes sure that fiscal deficit financing will not constitute a serious issue in the following years. A second point is that the analysis focuses on long-

term debt securities. Moreover, we narrow the country selection to the Southern economies (Greece, Portugal, Spain, Italy) with the addition of France and Ireland. Finally, one should keep in mind that SWFs can contribute to EU finances by more than just debt refinancing for example through Foreign Direct Investment (FDI).

The numbers are presented in Table 3.1.4. It should be noted that the data refer to debt securities with maturity not less than 12 months that are assumed to be refinanced strictly within this ten year horizon. The total refinancing needs reach 3291,2 billion Euros over the next decade which corresponds to 46% of total assets held by Sovereign Wealth Funds. Table 3.1.5. uses the same data only expressed as a proportion of GDP and government debt in 2014. The six selected countries need to refinance debt that represents more than 60% of their combined 2014 GDP and 55,4% of their government debt. Italy stands out as it needs to refinance debt equal to 84,6% of its GDP with France and Spain being better off compared to the rest of the sample. The terms of the Structural Adjustment Program for Greece have significantly lowered the refinancing needs for debt securities for the period under examination.

Table 3.1.4: Long-term debt refinancing needs of selected EU member states (2015-2024)

DEBT REFINANCING NEEDS (millions of €)	GREECE	ITALY	FRANCE	SPAIN	PORTUGAL	IRELAND	*Total refinancing needs per year*
2015	24.000	203.466	100.940	65.014	6.970	7.115	*407.505*
2016	7.000	186.083	147.140	80.149	15.290	7.990	*443.653*
2017	9.000	203.869	141.777	76.966	15.000	6.201	*452.814*
2018	4.000	145.151	112.677	58.362	15.920	13.181	*349.291*
2019	13.000	154.301	131.634	69.326	15.580	18.390	*402.231*
2020	5.000	114.498	95.182	55.188	14.260	26.121	*310.249*

2021	5.500	132.531	80.710	24.002	19.330	6.906	*268.979*
2022	7.000	67.333	78.790	21.952	5.620	5.315	*186.010*
2023	9.000	80.147	87.330	36.936	8.860	5.925	*228.198*
2024	8.500	75.691	67.673	67.133	14.300	8.976	*242.273*
Total refinancing needs per country	*92.000*	*1.363.071*	*1.043.853*	*555.029*	*131.130*	*106.120*	***3.291.203***

Source: National Authorities of the respective countries

Table 3.1.5: Debt refinancing needs as a proportion of current GDP and gross government debt

REFINANCING NEEDS	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	*Total*
GREECE											
as a % of 2014 GDP	13,0%	3,8%	4,9%	2,2%	7,1%	2,7%	3,0%	3,8%	4,9%	4,6%	*49,9%*
as a % of 2014 gross debt	7,4%	2,2%	2,8%	1,2%	4,0%	1,5%	1,7%	2,2%	2,8%	2,6%	*28,3%*
ITALY											
as a % of 2014 GDP	12,6%	11,6%	12,7%	9,0%	9,6%	7,1%	8,2%	4,2%	5,0%	4,7%	*84,6%*
as a % of 2014 gross debt	9,6%	8,8%	9,6%	6,8%	7,3%	5,4%	6,2%	3,2%	3,8%	3,6%	*64,2%*
FRANCE											
as a % of 2014 GDP	4,8%	6,9%	6,7%	5,3%	6,2%	4,5%	3,8%	3,7%	4,1%	3,2%	*49,2%*
as a % of 2014 gross debt	5,0%	7,3%	7,0%	5,6%	6,5%	4,7%	4,0%	3,9%	4,3%	3,3%	*51,6%*
SPAIN											
as a % of 2014 GDP	6,1%	7,5%	7,2%	5,5%	6,5%	5,2%	2,3%	2,1%	3,5%	6,3%	*52,2%*
as a % of 2014 gross debt	6,2%	7,7%	7,4%	5,6%	6,6%	5,3%	2,3%	2,1%	3,5%	6,4%	*53,1%*
PORTUGAL											
as a % of 2014 GDP	4,0%	8,8%	8,7%	9,2%	9,0%	8,2%	11,2%	3,3%	5,1%	8,3%	*75,8%*
as a % of 2014 gross debt	3,1%	6,9%	6,7%	7,1%	7,0%	6,4%	8,7%	2,5%	4,0%	6,4%	*58,8%*
IRELAND											
as a % of 2014 GDP	3,9%	4,4%	3,4%	7,2%	10,0%	14,3%	3,8%	2,9%	3,2%	4,9%	*57,9%*
as a % of 2014 gross debt	3,5%	3,9%	3,1%	6,5%	9,1%	12,9%	3,4%	2,6%	2,9%	4,4%	*52,3%*
TOTAL											
as a % of 2014 GDP	*7,6%*	*8,3%*	*8,5%*	*6,5%*	*7,5%*	*5,8%*	*5,0%*	*3,5%*	*4,3%*	*4,5%*	*61,7%*
as a % of 2014 gross debt	*6,9%*	*7,5%*	*7,6%*	*5,9%*	*6,8%*	*5,2%*	*4,5%*	*3,1%*	*3,8%*	*4,1%*	*55,4%*

Source: National Authorities, Eurostat, own calculations

The next table utilizes projections for GDP and gross government debt for 2015 and 2016 based on the European Commission's *European Economic Forecast* (2015). The comparison with Table 3.1.5 indicates that the projected data reveal somewhat smaller financing needs for the countries in question.

Table 3.1.5: Debt refinancing needs as a proportion of projected GDP and gross government debt

REFINANCING NEEDS	2015	2016
	GREECE	
% of projected GDP	12,71%	3,58%
% of projected gross debt	7,47%	2,25%
	ITALY	
% of projected GDP	12,56%	11,34%
% of projected gross debt	9,44%	8,63%
	FRANCE	
% of projected GDP	4,71%	6,74%
% of projected gross debt	4,85%	6,87%
	SPAIN	
% of projected GDP	5,97%	7,18%
% of projected gross debt	5,89%	7,01%
	PORTUGAL	
% of projected GDP	3,97%	8,56%
% of projected gross debt	3,19%	6,93%
	IRELAND	
% of projected GDP	3,75%	4,07%
% of projected gross debt	3,40%	3,77%
	TOTAL	
% of projected GDP	*7,54%*	*8,05%*
% of projected gross debt	*6,69%*	*7,16%*

Source: National Authorities, European Commission, own calculations

The next step is to gauge the relevant magnitude of the financing needs to the assets of the Sovereign Wealth Funds discussed in the previous section. This process is undertaken through a sensitivity analysis for the cumulative burden that would fall on SWFs should they provide funds for European states under certain assumptions for key parameters. The first parameter to set is the coverage ratio, that is the proportion of these countries' needs covered by the Funds. The baseline scenario assumes a 15% coverage ratio, which is probably large in order to try a conservative approach. Secondly we assume that the exchange rate between the dollar and the Euro is set at 1,2 dollars to the euro. The last parameter to be determined is the projected future growth rate of SWF asset holdings for which the exercise assumes different scenarios ranging from -2% to 8% with a 0.5% integral. The average annual growth rate for SWF assets was 12% for the time period from 2008 to 2014 so these projections can all be characterized as modest. Table 3.1.6 summarizes the cumulative burden for SWFs under different growth scenarios with the exchange rate and

the coverage ratio fixed as outlined above. For example, assuming a growth rate of 8% SWFs must dedicate 3,57% of their total assets to cover for 15% of refinancing needs for the six European nations by 2019

Table 3.1.6 Cumulative fraction of SWF holdings dedicated to Southern European debt refinancing

exchange rate: 1,2 coverage ratio: 0,15		year									
		2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
annual growth rate of total SWF assets	-2%	1,06%	2,26%	3,53%	4,57%	5,80%	6,81%	7,74%	8,46%	9,33%	10,27%
	-1,5%	1,06%	2,24%	3,48%	4,48%	5,65%	6,61%	7,47%	8,12%	8,91%	9,76%
	-1%	1,05%	2,22%	3,43%	4,39%	5,51%	6,41%	7,21%	7,80%	8,51%	9,28%
	-0,5%	1,04%	2,19%	3,38%	4,30%	5,38%	6,22%	6,96%	7,49%	8,14%	8,83%
	0%	1,04%	2,17%	3,33%	4,22%	5,24%	6,03%	6,72%	7,19%	7,78%	8,39%
	0,5%	1,03%	2,15%	3,28%	4,13%	5,11%	5,86%	6,49%	6,91%	7,44%	7,99%
	1%	1,03%	2,13%	3,23%	4,05%	4,99%	5,68%	6,27%	6,64%	7,11%	7,60%
	1,5%	1,02%	2,11%	3,18%	3,97%	4,87%	5,52%	6,06%	6,39%	6,80%	7,23%
	2%	1,02%	2,09%	3,13%	3,90%	4,75%	5,36%	5,85%	6,14%	6,51%	6,89%
	2,5%	1,01%	2,07%	3,09%	3,82%	4,63%	5,20%	5,65%	5,91%	6,23%	6,56%
	3%	1,01%	2,05%	3,04%	3,75%	4,52%	5,05%	5,46%	5,68%	5,96%	6,25%
	3,5%	1,00%	2,03%	3,00%	3,67%	4,41%	4,91%	5,28%	5,46%	5,71%	5,95%
	4%	1,00%	2,01%	2,96%	3,60%	4,31%	4,77%	5,11%	5,26%	5,46%	5,67%
	4,5%	0,99%	1,99%	2,91%	3,54%	4,21%	4,63%	4,94%	5,06%	5,23%	5,41%
	5%	0,99%	1,97%	2,87%	3,47%	4,11%	4,50%	4,78%	4,87%	5,01%	5,15%
	5,5%	0,99%	1,95%	2,83%	3,40%	4,01%	4,38%	4,62%	4,69%	4,80%	4,91%
	6%	0,98%	1,93%	2,79%	3,34%	3,92%	4,25%	4,47%	4,51%	4,60%	4,69%
	6,5%	0,98%	1,91%	2,75%	3,28%	3,83%	4,14%	4,32%	4,35%	4,41%	4,47%
	7%	0,97%	1,90%	2,71%	3,22%	3,74%	4,02%	4,19%	4,19%	4,23%	4,27%
	7,5%	0,97%	1,88%	2,68%	3,16%	3,65%	3,91%	4,05%	4,03%	4,06%	4,07%
	8%	0,96%	1,86%	2,64%	3,10%	3,57%	3,80%	3,92%	3,89%	3,89%	3,89%

Source: National Authorities, SWF Institute, own calculations

Even in the adverse event of a 2% growth deceleration for SWF holdings, the Funds would require 1/10 of their assets to cover the aforementioned needs. These results lead to a rather optimistic view of the capacity of SWFs to affect debt sustainability in the Euro area. The implications do not change significantly even after altering the other parameters such as the exchange rate. With the exchange rate against the UD dollar as high as 1,5 and annual growth rate of 4% the necessary proportion of assets would be 7,1% for the whole period, while an unrealistically high coverage ratio of 0,25 would require 10% of SWF assets by 2024 assuming 4% growth rate and exchange rate at 1,2.

Having established the capacity of Sovereign Wealth Funds to participate effectively in the refinancing needs of the European Union we now turn to the incentives behind this move from the viewpoint of the SWFs. To determine whether the incentives for such an investment behavior exist one must look into the reasons behind the very existence and operation of SWFs. Hence, motivation for an investment strategy exists if this strategy concurs with some of the general objectives of SWF operation.

The relevant literature (Drezner, 2008, Cohen, 2008, Griffith-Jones & Ocampo, 2009) distinguishes four general objectives for the establishment of SWFs. First of all, they provide a buffer against potential shocks to international commodity prices and help smooth the macroeconomic adjustment process that follows these events. Nonetheless, this has little application to the East and Southeast Asia economies that rely on large current account surpluses. Secondly, they act as an alternative to holding large amounts of foreign exchange reserves that remain idle. Despite the fact that they can serve as a tool for the Central Bank's exchange rate policy, they imply a certain opportunity cost. Another objective of SWFs is investment in technologically advanced corporations that allow for technology ad knowledge spillovers to the home economies. Finally, SWF holdings act as savings in the likely event of the depletion of natural resources. It certainly seems safe to assume that the first to objectives are in line with SWF investing in European financial markets, nevertheless we must keep in mind that European sovereign bonds are not the only alternative to foreign reserves and hedging against commodity price volatility. Peripheral bonds provide with satisfactory yields at the moment, however a substantial intervention from SWFs would reduce these spreads thus contradicting the investment strategy from their point of view. This could mean that the involvement of SWFs would be small in magnitude so as to keep the returns to the investment at relatively high levels. If, on the other hand, they require safety to satisfy the third objective analyzed above it is more likely they will turn to the risk-free markets of Northern Europe. The technology transfer objective does not seem to be in line with this kind of investment, therefore none of the four outlined objectives can be satisfied by the SWFs participating in the refinancing of the six European economies.

Nonetheless, helping stabilize the economy of the Euro-zone could be a strong incentive especially for commodity exporters.

From the European standpoint the motives and operations of SWFs come under scrutiny for two reasons. First, due to the increased state involvement in their operations and second because of fears that such investments can be used as weapons in the international geopolitical arena (Drezner, 2008). The inability and unwillingness of the private sector to provide with the necessary capital mitigates reactions regarding the first issue, however the later can prove to be rather important. Market analysts are concerned about the transparency of such entities and argue that actions undertaken by SWFs could further destabilize financial markets (Drezner, 2008). On the other hand, proponents of the Funds point out that private financial entities, for example hedge funds and private equity also lack transparency regarding their operations. There seems to be a cause for concern especially considering the lack of purely economic motives for SWF investment discussed above. Furthermore, since the recipients are financially weak economies, SWF participation and assistance could be seen as a "Trojan Horse" in European economic affairs. Another issue that could propagate reactions is the elevated role of China and Russia in the total assets held by SWFs. Attracting investments from these countries could imply stronger economic and geopolitical relationships between them and the European economies of the South. This could be viewed as an extortion strategy aiming at more lax policies decided at the European level, more specifically a more dovish approach by the European Central Bank (ECB). Finally, in the event that European debt markets stabilize after the intervention by SWFs, this could be seen to highlight the inefficiencies of the Euro-zone in the economic and political sphere and in a more pessimistic scenario it could mark the shift of economic power gradually away from the West.

It is evident that the dilemma that the Euro-zone faces in this matter is substantial. On the one hand, such an intervention is desirable as a financial relief and on the other the political repercussions can be adverse. European policy has a pivotal role to play in this context and can mitigate the risks and concerns for SWF participation. In the sense that the ECB continues its unconventional monetary policy through Quantitative Easing (QE) and

Longer Term Refinancing Operations (LTRO) the SWFs could provide financing to diversify their portfolios without playing the crucial role of the lender of last resort. It is therefore evident that the future developments in the EU regulatory framework concerning SWF investments will be of the highest importance to determine whether the EU and the SWFs can act as partners or enemies.

3.1.2 Sovereign Wealth Funds and BRICs

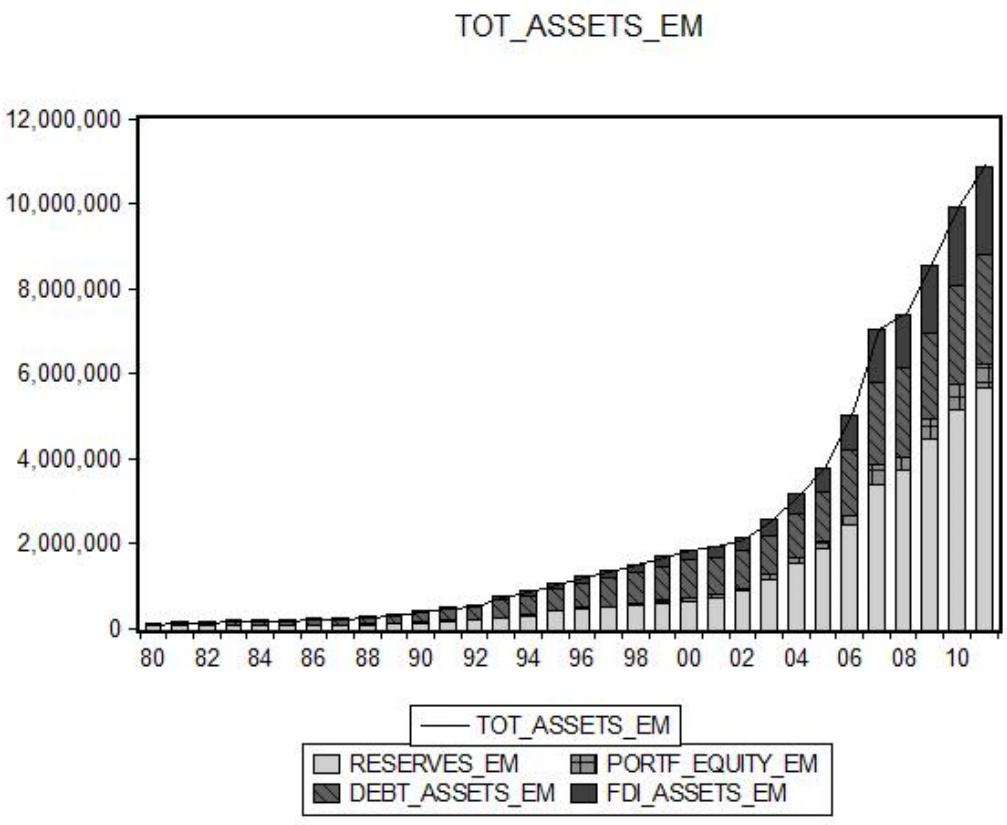
Brazil, Russia, India and China constitute a country group with exceptional economic growth rates and have upgraded their positions in the global economic system in various ways. The importance of pension funds in these economies is not identical ranging from 15% of GDP in Brazil (2007) to less than 1% of GDP in China. In 2008, the International Working Group of Sovereign Wealth Funds published a report under the title "Principles and Practices for SWF - Santiago Principles" which outlined voluntary guidelines for the investment behavior of SWFs. In Brazil this led to the establishment of the Sovereign Fund of Brazil which promotes investment in areas of strategic interests for the Brazilian economy. In Russia the fiscal gains from high oil prices led to the creation of the Oil Stabilization Fund in 2004, which was split into a Reserve Fund and a Future Generations Fund in 2008. The former is financed by revenues from oil and gas as well as the federal budget. Together with the second Russian SWF, the Stabilization Fund they helped stimulate domestic demand in the aftermath of the severe recession of 2009. Up to now Russian funds have relied on a low-risk portfolio, nevertheless the tensions with the EU arising from the involvement in Ukraine cast doubts on whether the SWFs can balance their deteriorating fiscal position. China is the home country to the fourth and fifth largest SWFs, namely the Investment Company of State Foreign Exchange Management (SAFE) and the China Investment Corporation (CIC). The SWFs have increased their participation in mining and resource-related companies, especially after the financial crisis of 2009. This marked a shift away from the financial sector and also away from volatile sectors in the EU and North America in favor of fellow BRIC economies, Mexico and the Middle East.

3.2 Emerging and Developing Countries holdings of EU assets

3.2.1 Overview

Apart from the portfolio investment in European markets by Sovereign Wealth Funds discussed in the previous section capital inflows to the European Union from developing and emerging markets takes two other forms. The first one is currency reserves held in Euros and the other is Foreign Direct Investment (FDI). As mentioned above, the integration of emerging and developing economies in the global financial system has been rapid since the turn of the new century. The accumulation of large trade surpluses combined with the surge in capital inflows led to the accumulation of foreign exchange reserves from these countries. Figure 2.3.1 below clearly shows that reserves still represent a high portion of the international investment position of emerging economies. The diversification of their portfolio, on the other hand is evident in the Figure especially after 2005.

Figure 3.2.1 Total external assets of Emerging Economies - USD millions



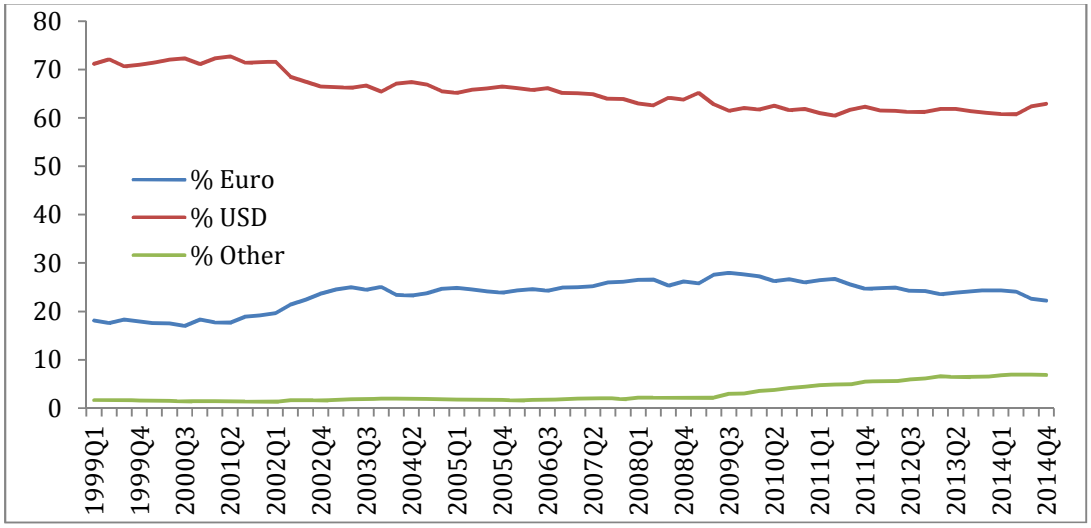
Source: IMF

Having analyzed the structure and potential role of SWFs, we turn to the other two channels of finance from emerging economies to Europe, namely foreign exchange reserves and FDI. We focus on the trends in the importance of the Euro in the developing countries' foreign exchange basket and present an overview of the key developments in their FDI in the EU. On top of that, emphasis is given in the special role of the BRIC economies (Brazil, Russia, India, China) in terms of direct investment in the European market.

3.2.2 The Euro within foreign exchange reserves

Since its adoption, the Euro has maintained its position as the second biggest component in global currency reserves. Figure 2.3.2 shows that since 2002, 20 to 22% of global reserves have been held in Euro-denominated assets.

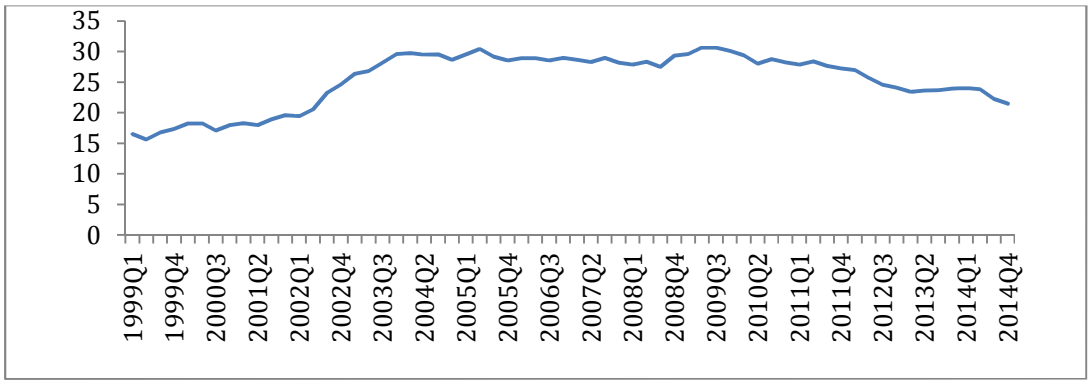
Figure 3.2.2 Share of World Foreign Exchange Reserves



Source: IMF

In the first years of the common currency low borrowing costs almost converged within the Euro area. The surge in currency holdings was mainly drive by the emerging economies which held about two thirds of total reserves by 2014. This could prove to be a significant source of financing for Europe. Nonetheless, the accumulation of Euro-denominated assets seems to be heavily dependent on the financial stability of the Euro-zone and the EU in general. The data presented in Figure 2.3.3 reveal that the share of Euro in the currency basket for emerging countries has declined after 2009 with the eruption of the financial crisis.

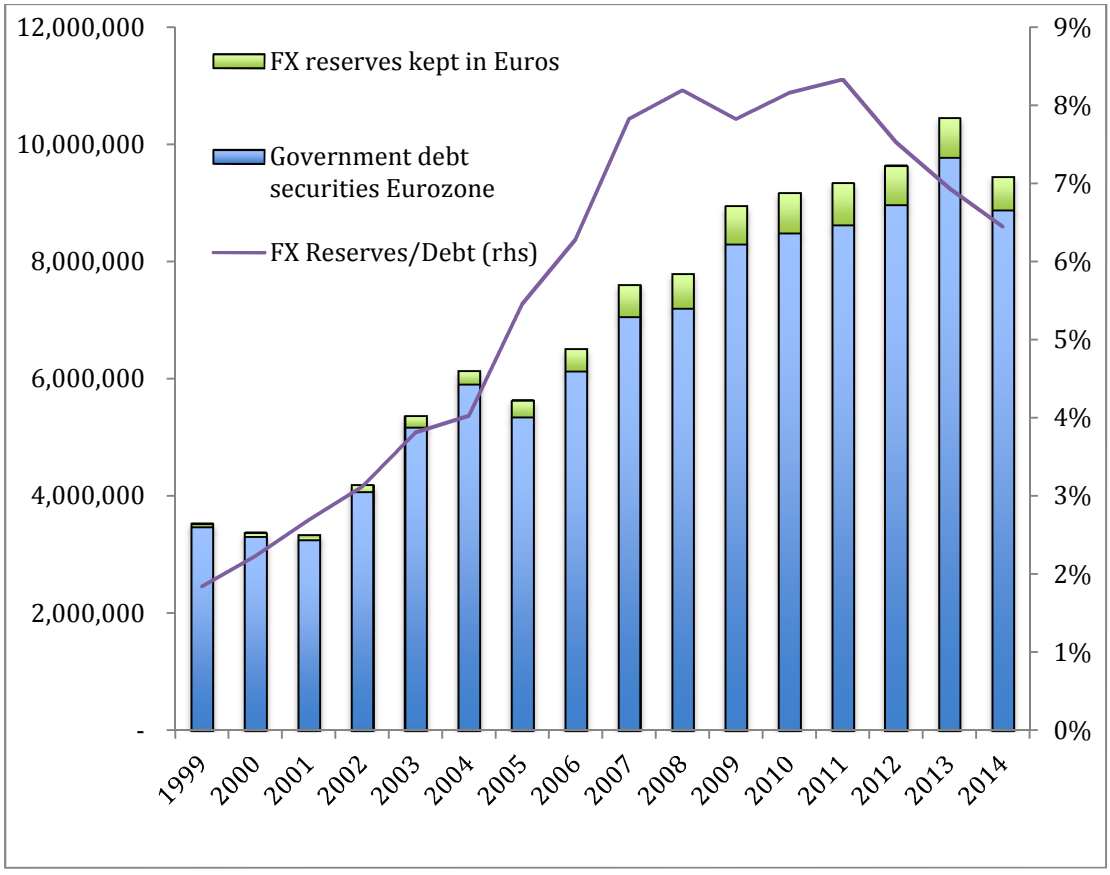
Figure 3.2.3 Emerging and Developing Countries Reserves - % EUR



Source: IMF

Although the absolute value of Euro holdings has not altered significantly, an increasing share of other currencies while the US dollar share remains fairly constant has contributed to the fall in the share of Euro-denominated assets. Moreover, the financial stress in most European economies has proved detrimental in this issue, indicating that Europe has seen its financing through reserves decline in the time it was most needed. The sovereign debt crisis caused a fall in reserves from 8,9% of total government debt in 2010 to 6% in 2014 (Figure 2.3.4). To sum up, recent developments show that, although the Euro is an important currency in global foreign exchange reserves, it is highly unlikely that these reserves can make a significant contribution towards stabilizing troubled European finances.

Figure 3.2.4 Reserves and Government Debt – USD millions



Source: IMF

3.2.3 Foreign Direct Investment to Europe

The impact of FDI on growth depends on the type of FDI, the investing firm's characteristics and the recipient country macroeconomic conditions and policies. Among policy variables, political stability and market friendly reforms are significant pull factors for foreign capital, whereas incentives to invest through multilateral or bilateral treaties also facilitate FDI. Home country infrastructure and human capital is also a decisive factor for FDI inflows and a competitive environment can urge a multinational company to engage in activities in a certain country. The role of developing economies in FDI has upgraded sharply after 2010 (UNCTAD, 2013). In 2012 FDI inflows for developing countries surpassed the ones to developed ones for the first time. On top of that outward FDI flows from BRICs and South Africa have also exhibited an upward trend with an exception for 2009 as can be seen in Table 3.2.5

Table 3.2.5: Outward FDI flows in million USD 2000-2013 at current prices and exchange rates

Year	2000	2001	2002	2003	2004	2005	2006	2007
Brazil	2281.59	-2257.59	2482.11	249.30	9806.99	2516.70	28202.49	7066.66
China	915.78	6885.40	2518.41	2854.65	5497.99	12261.17	21160.00	26510.00
India	514.45	1397.44	1678.04	1875.78	2175.37	2985.49	14284.99	17233.76
Russian Federation	3176.78	2532.58	3532.65	9727.13	13782.03	17879.65	29993.15	44801.21
South Africa	270.61	-3177.89	-397.98	565.12	1350.06	930.29	6063.31	2965.92
Total	7159.20	5379.94	9813.22	15271.98	32612.44	36573.30	99703.94	98577.55

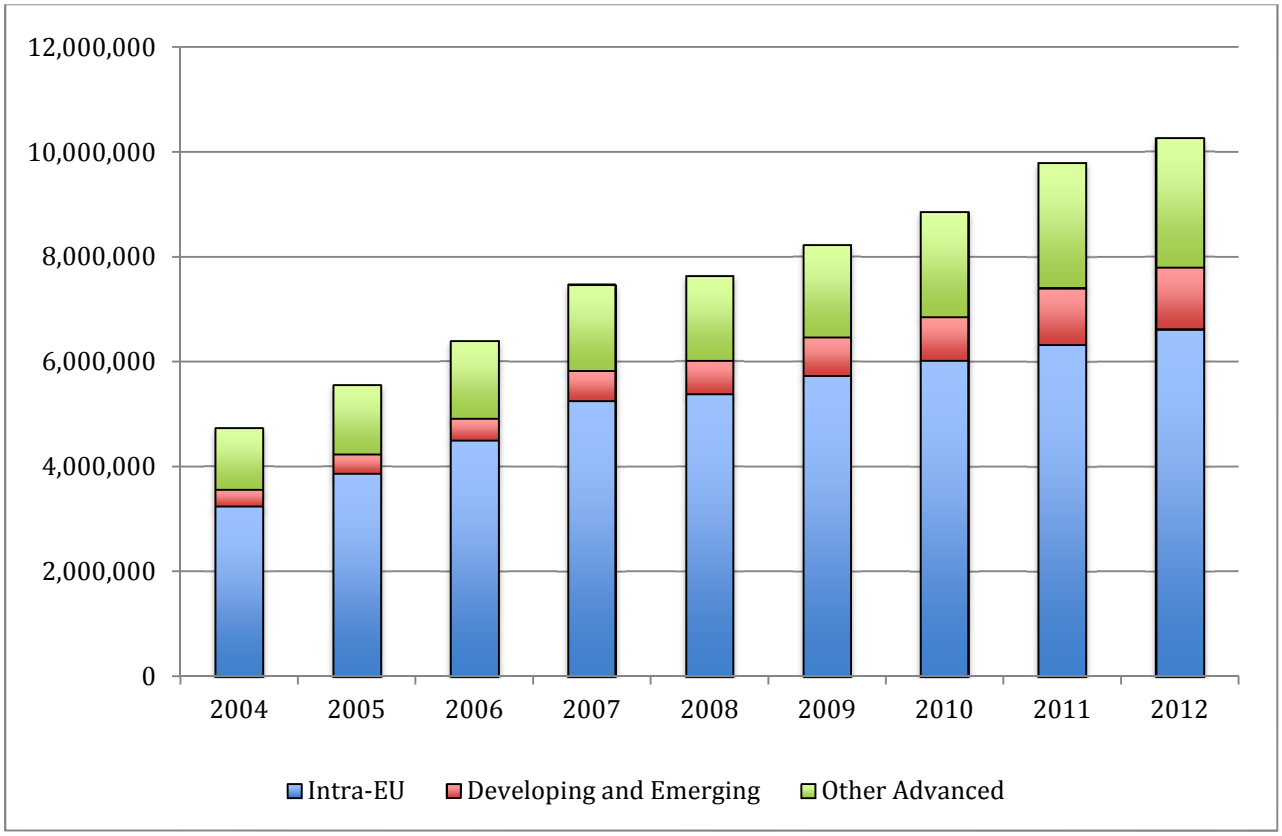
Year	2008	2009	2010	2011	2012	2013	Total	Percentage Total
Brazil	20457.1	-10084.226	11588	-1029	-2821.4	-3495.83	64962.4	5.38
China	55910	56530	68811	74654	87804	101000	523312	43.3
India	21147.4	16031.302	15933	12456.1	8485.7	1678.74	117877	9.75
Russian Federation	55662.6	43280.522	52616	66850.8	48822.4	94907	487565	40.34
South Africa	-3133.7	1151.4491	-75.67	-256.847	2987.59	5619.85	14862.1	1.23
Total	150043	106909.05	148872	152675	145278	199710	1208579	100

(Source: Authors after UNCTAD Statistics)

The EU is a major recipient of FDI and the region as a whole was in the first place globally in terms of inward FDI stocks in 2013 (OECD, 2014). Nevertheless, the economic slowdown has had a detrimental effect reducing the EU share in total FDI stock from 38% in 2007 to around 30% in 2014. The inward FDI flow, on the other hand, has decreased sharply from 40% to 17%

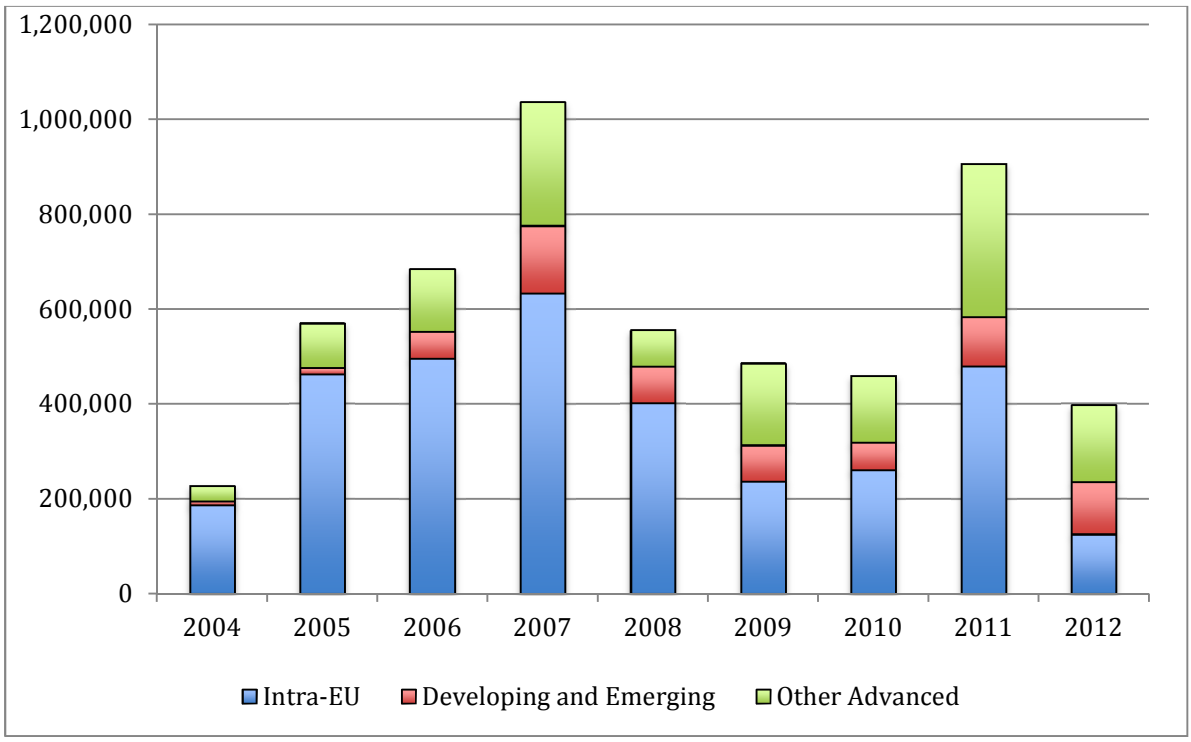
over the same period. The data up to 2012 are presented in Figures 3.2.6 where one can notice the steady increase in FDI positions and the volatility embedded in inward flows. The largest share of FDI was intra-EU. According to Eurostat intra-EU FDI constitutes more than 66% of total FDI stock and about 58,8% of FDI flows in the region.

Figure 3.2.6 EU-27 FDI Inward Positions – EUR Millions



(Source: Authors after UNCTAD Statistics)

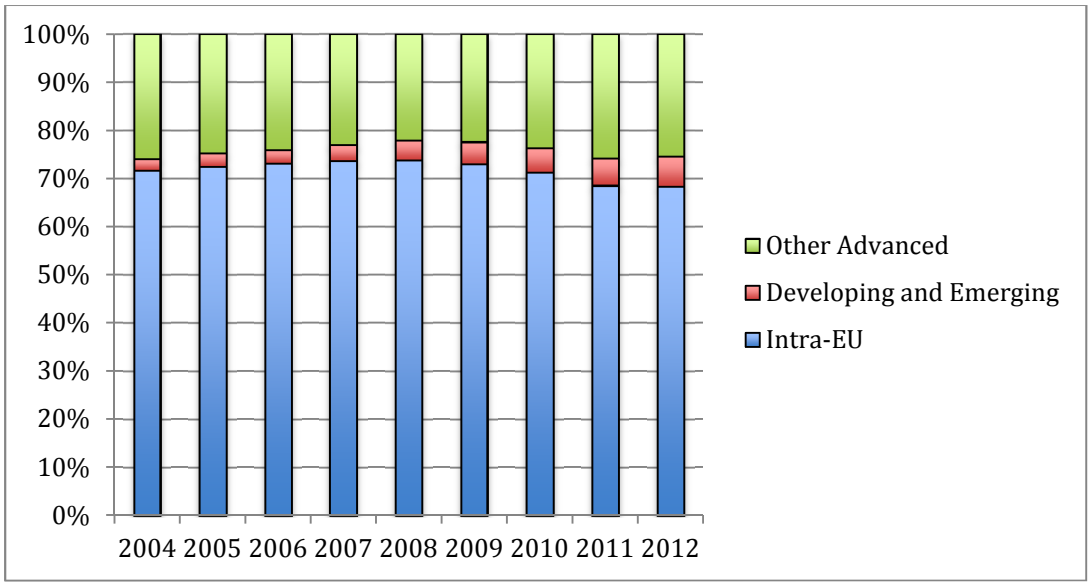
Figure 3.2.7 EU-27 FDI Inward Flows – EUR Millions



(Source: Authors after UNCTAD Statistics)

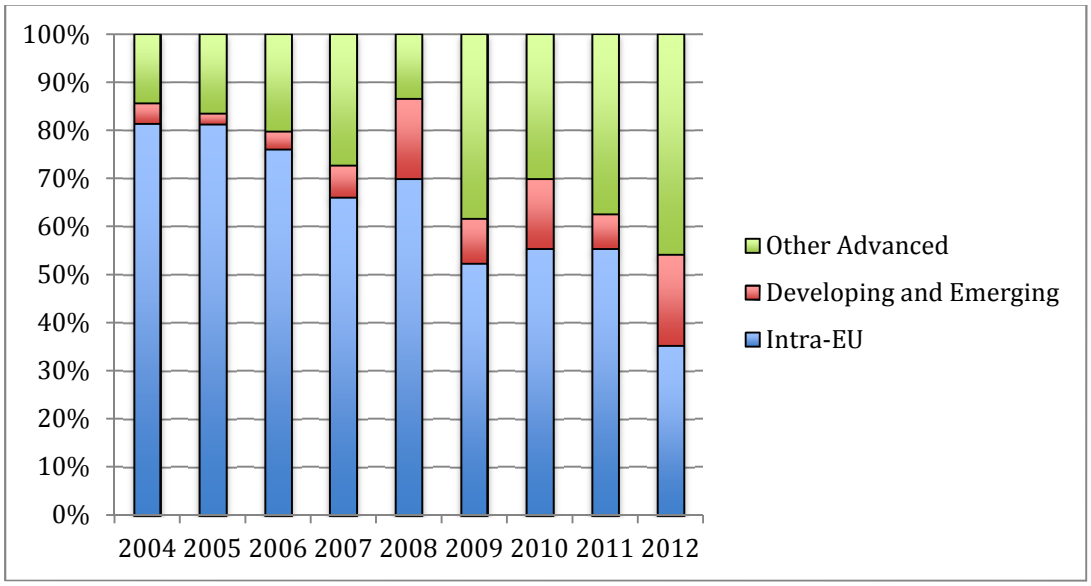
The severe economic downturn after 2008 and the ongoing sovereign debt crisis in Europe have contributed to the steady decrease in the share of intra-EU FDI both in terms of positions and flows. This resulted to an increased share for other advanced countries but also for developing and emerging economies as depicted in Figure 3.2.8. Inflows from developing countries have more than quadrupled during the 2008-2012 period from 4,3% to 18,8%, while the increase for advanced economies over the same period is from 14,3% to 45,8%.

Figure 3.2.8 EU-27 FDI Inward Positions Shares



(Source: Authors after UNCTAD Statistics)

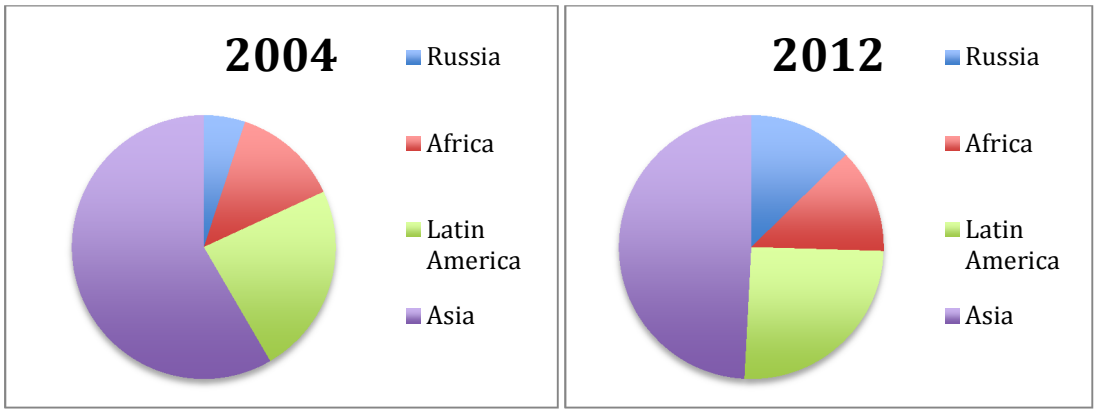
Figure 3.2.9 EU-27 FDI Inward Flows Shares



(Source: Authors after UNCTAD Statistics)

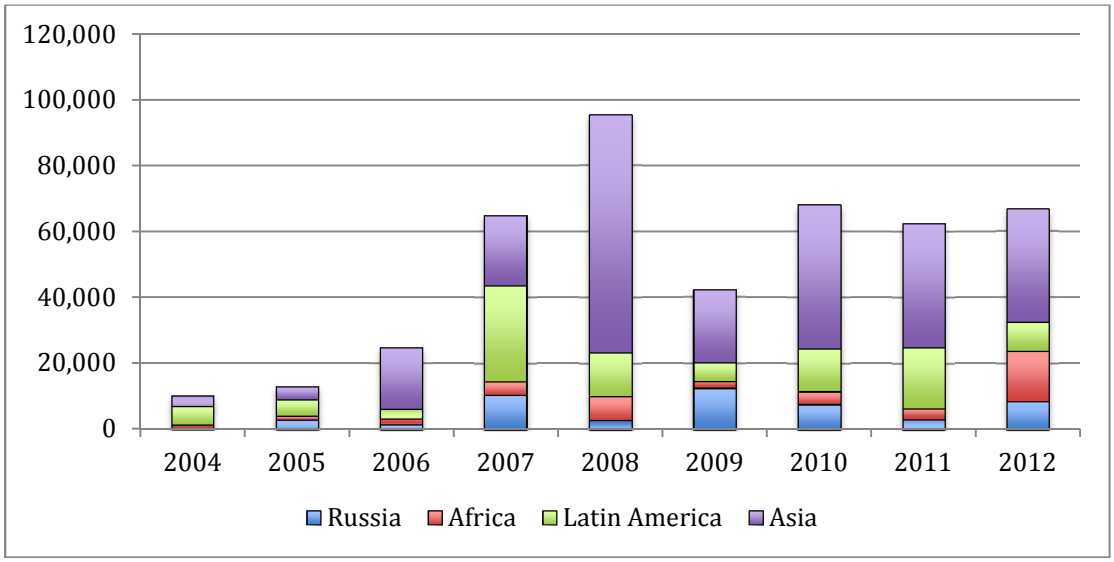
Our main focal area is FDI from emerging and developing economies. As far as the region of origin is concerned, Asia is the major investor, despite the fact that its share in FDI stock fell from 58% to 50% between 2004 and 2012. Figure 3.2.10 below shows the composition of FDI stock and flows, with the increased presence of Russia standing out.

Figure 3.2.10 – Emerging and Developing Countries FDI position in the EU, Regional Shares



(Source: Authors after UNCTAD Statistics)

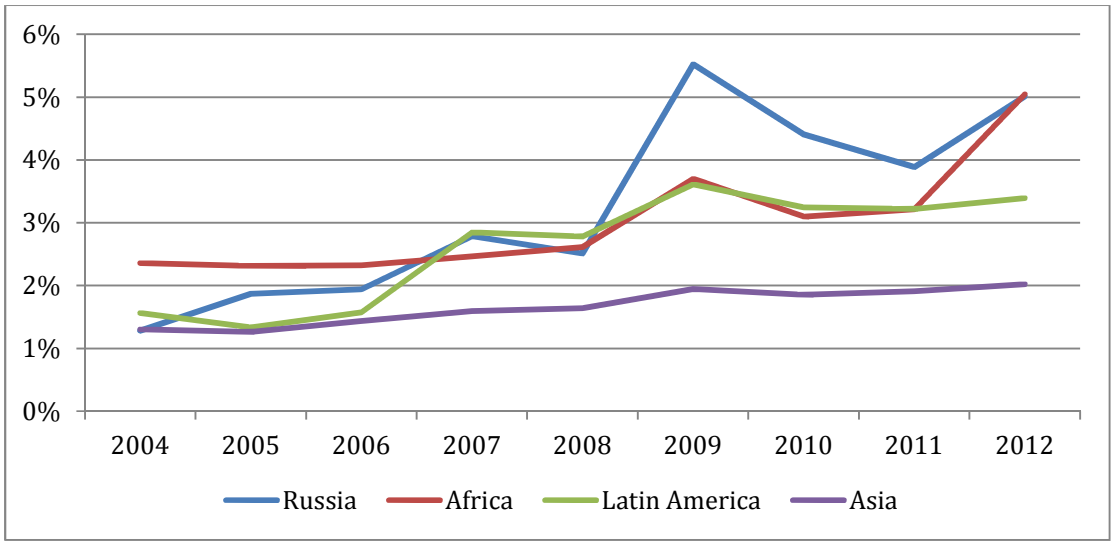
Figure 3.2.11 Emerging and Developing Countries FDI Flows to the EU – EUR millions



(Source: Authors after UNCTAD Statistics)

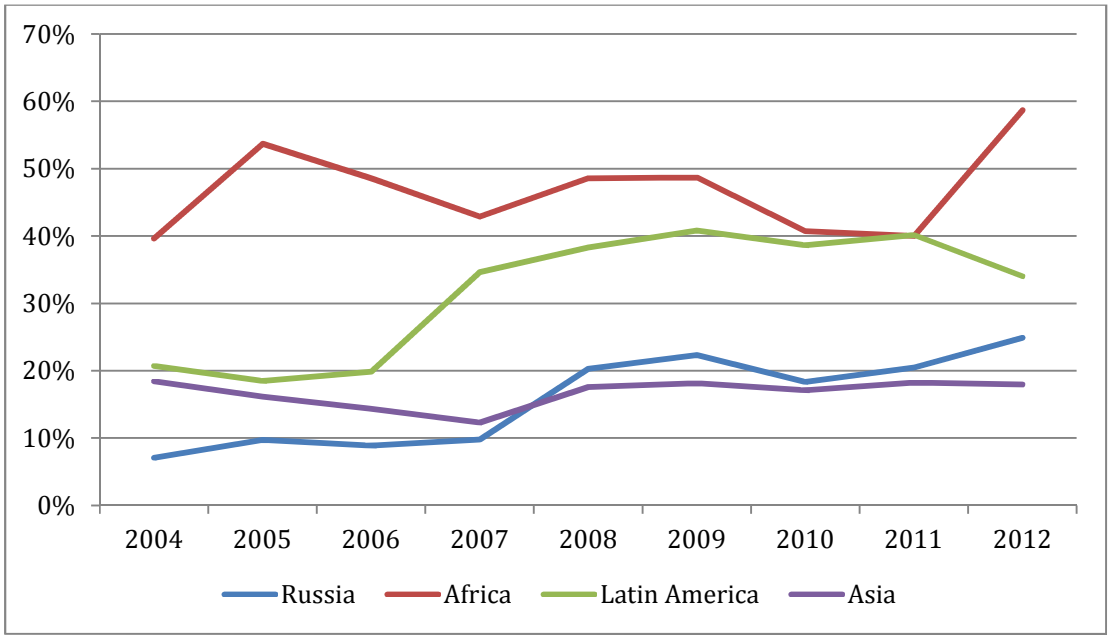
FDI inflows from emerging economies have shown a steady recovery since 2009, yet lie below their pre-crisis peaks. An interesting point is highlighted at Figure 3.2.12 where FDI is scaled by the regions' GDP. Asia exhibits the lowest rate, however this is probably the result of the very high growth rates prevailing in the region.

Figure 3.2.12 FDI to EU – % GDP



(Source: Authors after UNCTAD Statistics)

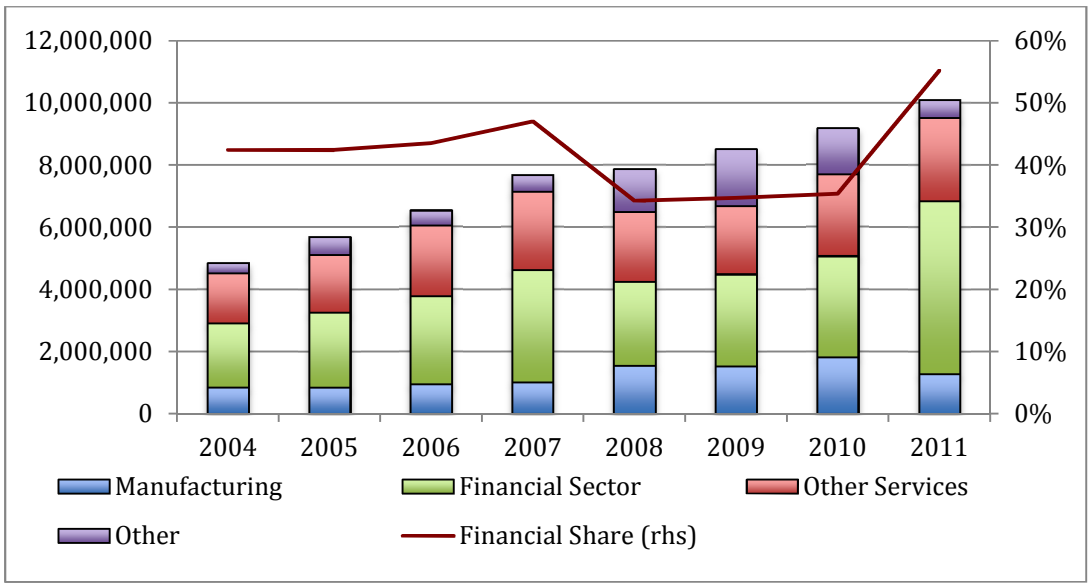
Figure 3.2.13 FDI to EU – % Total FDI



(Source: Authors after UNCTAD Statistics)

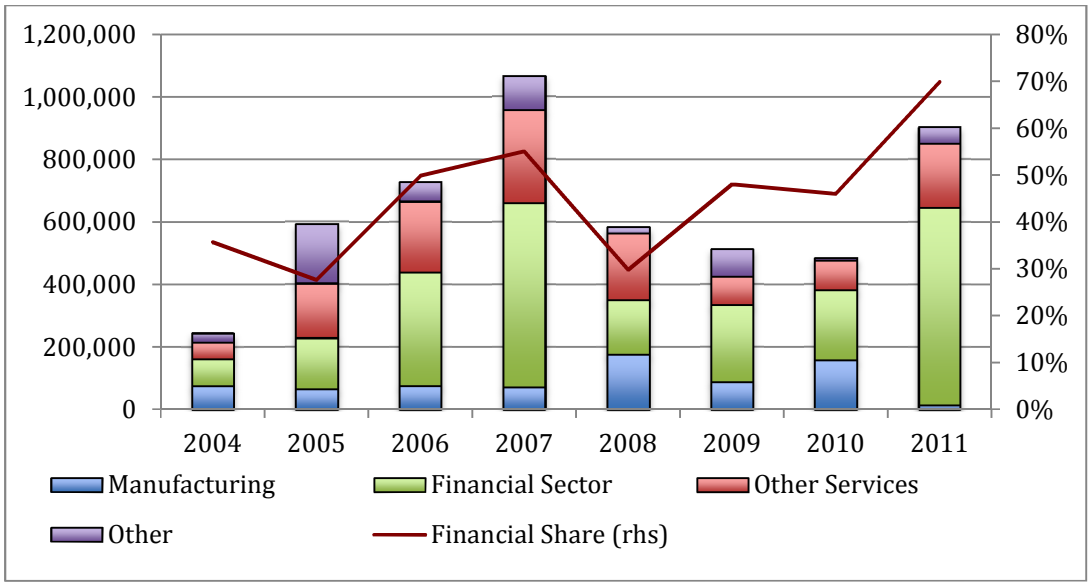
The sector allocation of FDI is of great importance. For all of the 2004-2011 period more than FDI flows and positions are targeted to the EU services sector. More than two thirds of that is allocated to the financial sector (Figure 3.2.14)

Figure 3.2.14 FDI Inwards Positions by Sector – EUR millions



(Source: Authors after UNCTAD Statistics)

Figure 3.2.15 FDI Inflows by Sector – EUR Millions



(Source: Authors after UNCTAD Statistics)

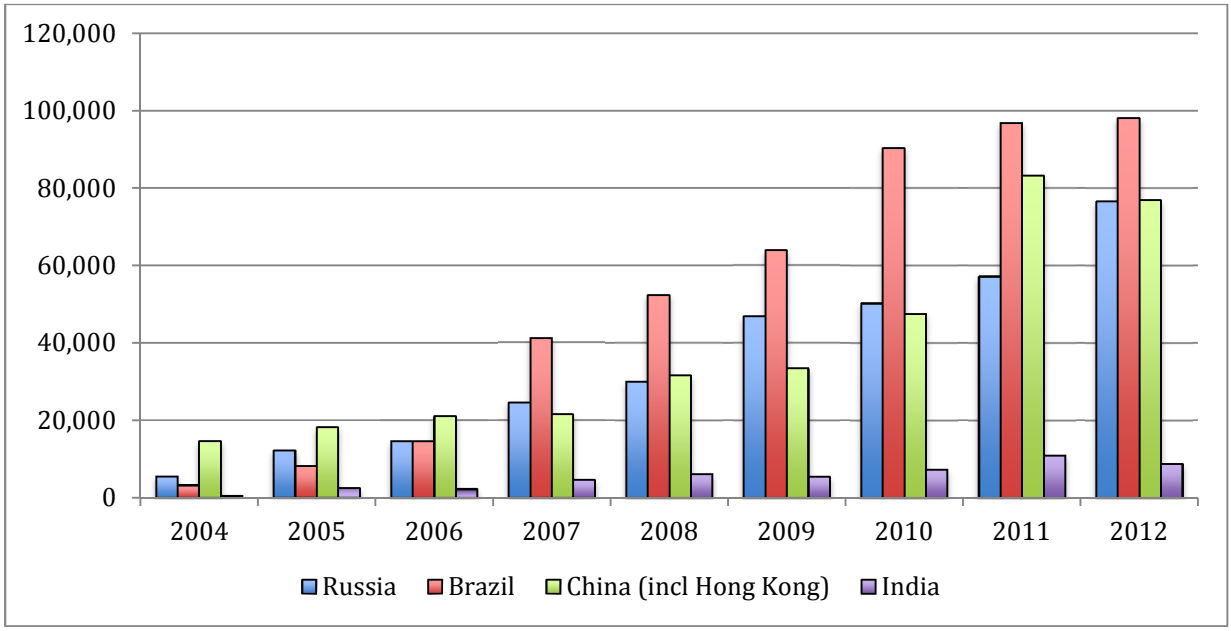
The main conclusion of this section is that the fall in intra-EU FDI has put a downward pressure in total investment activity despite the increasing share for emerging economies. This upward trend in FDI stemming from developing countries can be attributed to the elevated growth rates of specific regions and the higher degree of openness to the globalized

economy observed after 2000. Under the assumption that this process will be ongoing, FDI can be a source of financing for the EU for the years to come, however the sectors of allocation will also affect outcomes.

3.2.4 FDI from BRICs

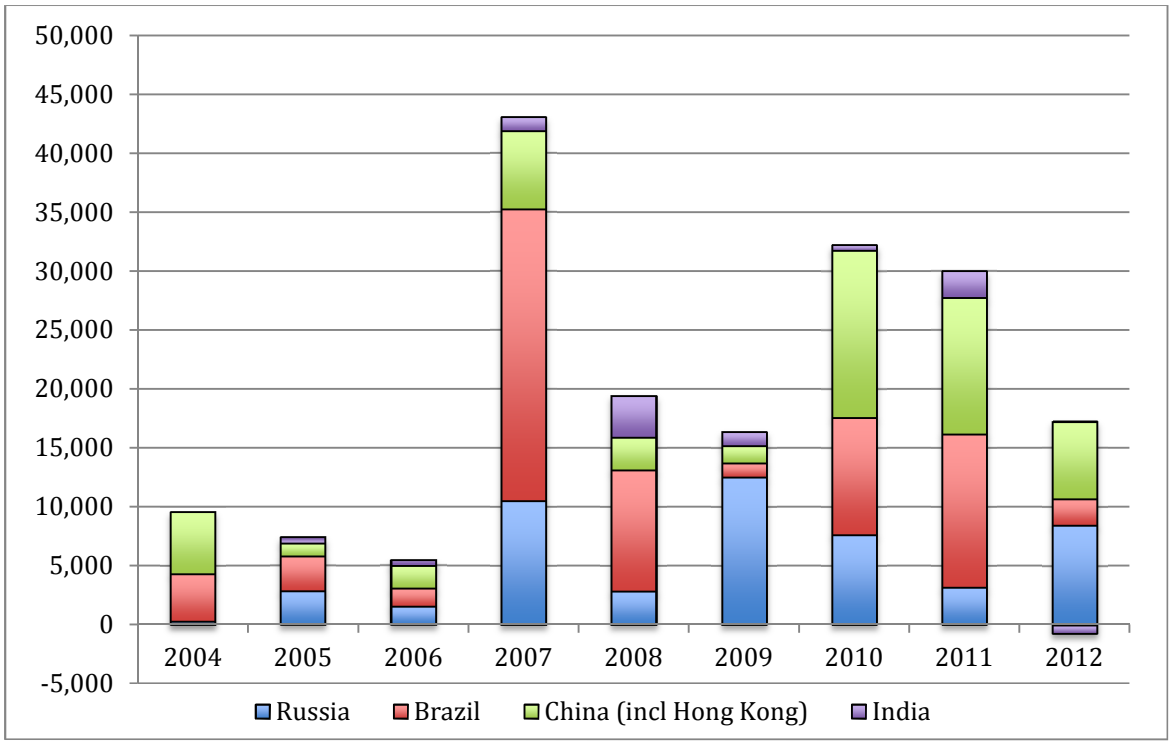
Within the developing world, the four rapidly growing economies under the BRIC acronym have also increased their FDI positions substantially with Brazil being the top investor throughout the years. Figure 3.2.16 paints a similar picture to the one for the emerging economies in total, as FDI flows have not reached the high levels of 2007 after the financial crisis.

Figure 3.2.16 FDI Positions from BRIC Countries to EU-27 – EUR Millions



(Source: Authors after UNCTAD Statistics)

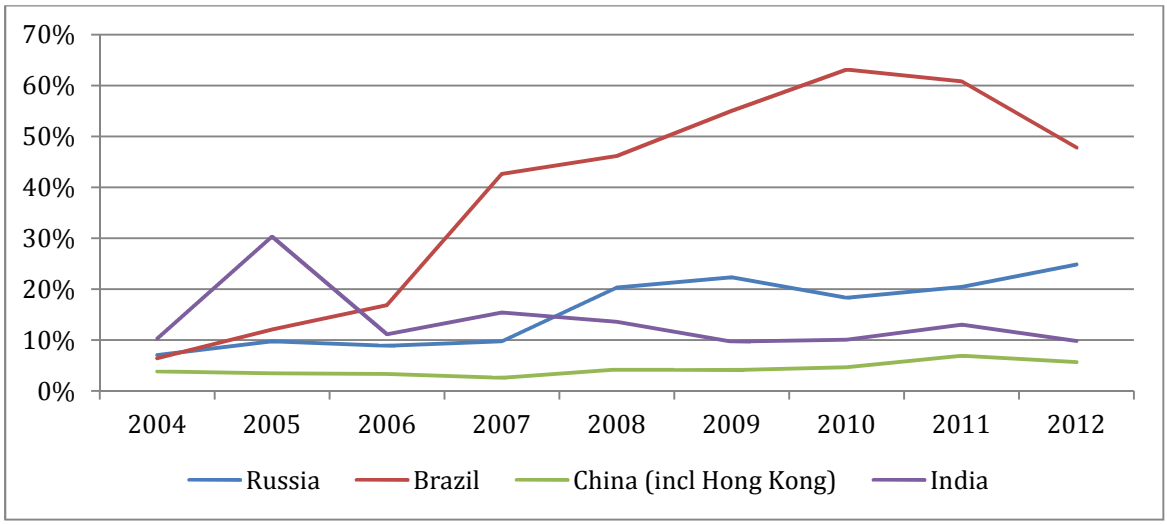
Figure 3.2.17 FDI Flows from BRIC Countries to EU-27 – EUR Millions



(Source: Authors after UNCTAD Statistics)

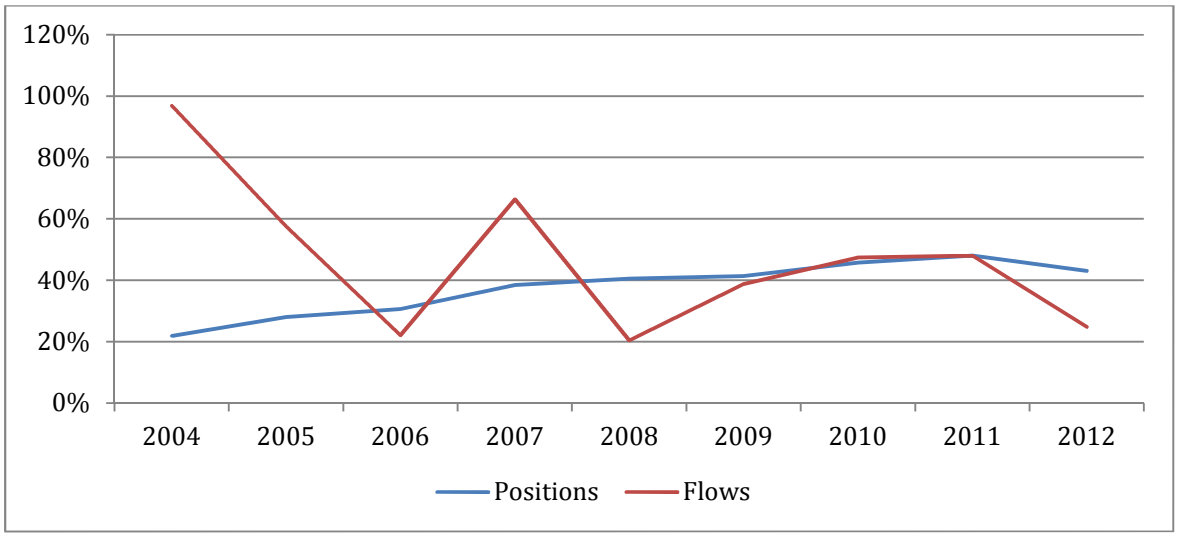
Brazil also stands out for the increased role of the EU as a destination country for investment. A similar trend is exhibited in the data coming from Russia, whereas India and China have reduced their exposure to the EU after 2007. Furthermore, the exceptional economic growth rates for the BRIC economies have contributed to a growing FDI share compared to the total of emerging economies since 2004. In terms of stock the proportion has risen from 20% to 50% from 2004 to 2011, while flows grew steadily to reach more than 45% over the same period.

Figure 3.2.18 FDI Positions From BRIC Countries to EU-27 – Share of Total Outward FDI



(Source: Authors after UNCTAD Statistics)

Figure 3.2.19 FDI Positions From BRIC Countries to EU-27 – Share of Total FDI Positions from Developing and Emerging Countries



(Source: Authors after UNCTAD Statistics)

In line with the previous discussion, BRIC countries invest a growing share of their capital to the financial sector of the European economy. Brazil has the highest share of financial sector FDI, however the proportion is growing for Russia as well as for China. Overall, investment is concentrated on larger firms as expected. The Value added over total FDI position varies significantly within this country group. Brazil's investment exhibit a very low ratio of 0,0007

that can probably be explained by the allocation of their investment to the financial sector. The highest ratio is observed in Indian FDI positions while China is approximately at the mean level of 0.15. The fact that Brazil and Russia concentrate more on the financial sector while increasing their provision of investment to the EU makes the generation of value added from these investments improbable.

3.2.5 Hedge Funds

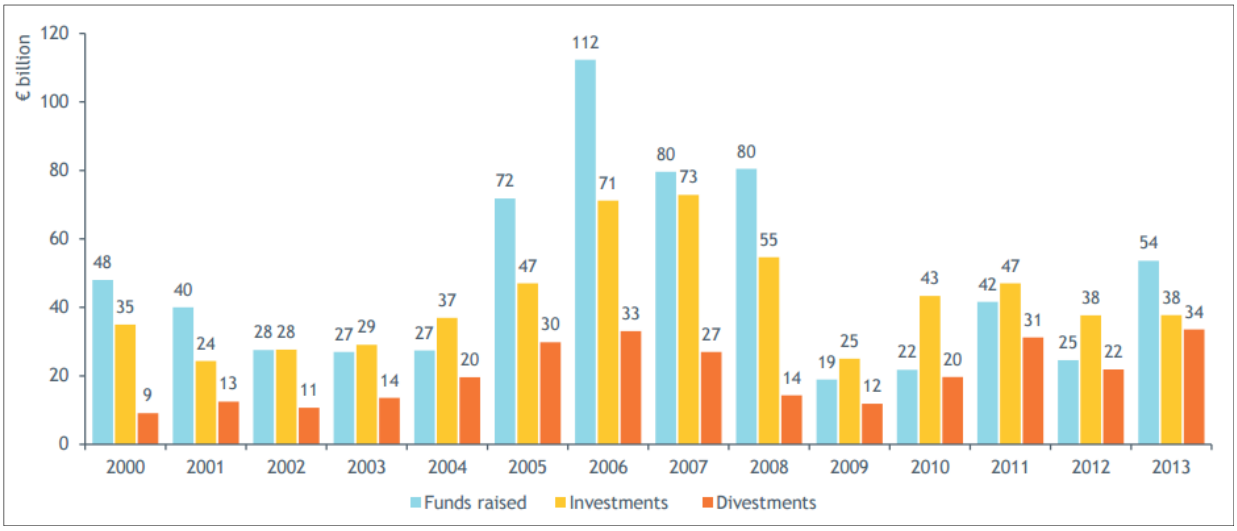
Hedge Funds were severely affected by the global financial crisis in 2008 and their total assets shrank from 1,2 trillion dollars in 2008 to 786 billion dollars in 2013. Although a universal definition is lacking, hedge funds can be described as undertaking collective financial investment but with the legal status of partnerships that places hedge funds outside the normal regulation of financial intermediaries. European hedge funds have reduced their activity over the last six years for two reasons. The obvious one has been the financial and sovereign debt crisis and the other was the establishment of the Alternative Investment Fund Managers Directive (AIFMD) regulations in 2013. Despite the modest pick-up in 2013, only 8% of the new hedge fund managers that entered the market in 2013 were based in Europe. In the emerging markets and especially the Asian-Pacific region, the hedge fund industry is extremely dynamic. The new Securities Investment Funds Law in China (Preqin, 2013) and the authorization of the first Indian hedge fund constitute landmark developments for the industry in the region.

3.2.6 Private Equity and Venture Capital

Private Equity and Venture Capital are another form of collective investment institutions organized, like hedge funds, as partnerships to avoid public disclosure, but committing funds to the equity of non-financial companies and new businesses for periods of between five and ten years (Toporowski 2012). These have contributed noticeably to equity investment in Europe after 2000. The European Private Equity and Venture Association (EVCA) reported in 2013 that 1455 European Private Equity Funds accounted for 400 billion Euro of total

commitments for the period from 1980 to 2013. Their activity peaked in 2006 (Figure [...]) benefiting from low interest rates and favorable credit conditions.

Figure 2.5.1: "Industry statistics" capturing activity by private equity firm's European offices (EVCA, 2014)



Source: European Private Equity and Venture Association

Nevertheless, with the emergence of problems in the European and other developed markets, there has been a shift away from investment in those markets. A substantial proportion of new capital has been allocated toward the BRIC economies after 2010 (Sutro, 2013). Venture Capital deals in BRICs reached 512 in 2012 compared to 270 deals in 2009, with their aggregate value reaching a peak of 7 billion dollars in 2011. Each market, however features different characteristics that constitute pull factors for Venture Capital and Private Equity. In Brazil, for example, it is the historically long period of macroeconomic stability and the adoption of much needed structural reforms that attract investment along with favourable demographic developments. Russia exhibits contradictory signs, with a growing market but lack of necessary infrastructure along with poor regulatory environment and state intervention. Among BRICs, China has received the majority of venture capital deals, while Indian PE market is still underdeveloped. The overall assessment for Europe is that PE and Venture Capital opportunities exist, mostly in China and that investment approaches

This project has received funding from the European Union's Seventh Framework Programme
for research, technological development and demonstration under grant agreement no 266800

deviate within the country group based on macroeconomic and idiosyncratic characteristics of these economies.

4. Conclusion: Europe's Role in International Finance

This paper addresses some of the policy issues arising from the new era in global finance. In what can be considered a paradigm shift, the emerging and developing economies are gradually opening their economies and participating far more actively in the financial markets. From the European perspective, this has implications on the EU's aid policy, its trade and financial agreements with the developing world and also on potential sources of finance and investment in this period of suppressed demand and high unemployment.

This paper has concentrated on the role of the developing and emerging markets in the international financial system because it is this segment of that financial system that is most vulnerable to shifts in commodity prices that may abruptly escalate the need for external financing in commodity exporting countries, such as South Africa, Brazil, and Indonesia. The paper has emphasized the increasing disengagement of international capital flows from the simple financing of trade imbalances, and the influence of debt maturity on financing requirements. The asymmetric global engagement of the European Union, concentrating on trade agreements with other OECD countries, whose cross-border financial liabilities are hedged with foreign assets, and on the mobilization of private capital flows to developing and emerging economies, whose liabilities are inadequately hedged with foreign assets, reinforces the weaknesses in the international financial system. The unhedged, increasingly private-sector cross-border liabilities of the emerging economies are vulnerable to changes in monetary policy in the United States. An engagement with developing countries that focuses solely on trade and the provision of finance for development, to the neglect of systems for debt management, increases most directly the vulnerability of those countries and through that the vulnerability of the international financial system.

EU aid policy has evolved over the last fifteen years and is in accordance to the notion of financial liberalization and the importance of private initiative. Combined with the redefined

Sustainable Developmental Goals this has increased the promotion of the financial sector as an engine for growth and development in the developing countries. In addition, a high degree of private participation in the aid process is encompassed under the aegis of blending mechanisms, which combine grants with loan and equity schemes to catalyze private and public investment. The liberalization of the financial account has also increased gross private indebtedness in the developing and emerging economies. Capital flows do not compensate for current account deficits, as trade balances are favorable, but is connected to short-term portfolio flows that could have destabilizing repercussions in an adverse scenario. Nevertheless, net external debt is decreasing after 2000 for the countries in question.

The New International Financial Architecture assigns new roles for developing nations in the global financial markets. The accumulation of surpluses with the form of growing foreign currency reserves or the assets of Sovereign Wealth Funds (SWFs) could provide new channels of financing for developed economies and the EU in particular. As far as SWFs are concerned, our analysis shows that with the most modest assumptions they can cover a substantial part of the financing needs for financially stressed European economies. Nevertheless, scholars and policymakers are concerned with the shift of economic power away of the Western sphere. On top of that, emerging economies seem to lack the economic incentives to act in such a way, thus generating greater suspicion in the event of their future interference in the region. Furthermore, as long as the emerging economies continue to enjoy world-leading growth rates and further open up to international markets, it is safe to expect the increased inward and outward FDI activity to persist. Nonetheless, the data show that a large share of BRIC FDI is dedicated to the financial sector of advanced economies with marginal effects on value added.

However, Europe's participation in global financial markets reflects very much the constraints on fiscal and monetary policy in Europe. Fiscal austerity and the search for 'macroeconomic balance', defined as precautionary surpluses in the government balance and balance in the foreign trade of individual countries in Europe, have undermined the

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government bond markets essential for the proper functioning of private capital markets (Minsky 1964). Monetary policy, as conducted by the European Central Bank and central banks in the Euro area, in its turn has been inadequate in assuring the liquidity of capital markets in Europe. These constraints have two consequences for Europe's participation in global financial markets. First of all, European development assistance is excessively reliant upon joint ventures with private finance ('blended finance'), as evidenced by the growth of private capital flows to developing countries. The positive side of such private-public collaboration is that such collaboration can 'leverage-up' more modest public sector development commitments. The negative aspect of such collaboration is that it also leverages up public sector liabilities when the emerging market crisis when private sector liabilities are added to the claims on foreign currency in the developing country or emerging market, while public sector development agencies come under pressure to support projects affected by private sector illiquidity.

Secondly, the weak liquidity of European capital markets challenges the idea of Europe as a financially-developed region that can provide a stable component of international portfolios. The limits the role that the Euro can play in international financial intermediation to the fringes of the Single Market, where Euro reserves can play a basic part in exchange rate stabilisation. In effect this excludes the possibility of Euro capital markets challenging US dollar markets as lynch-pins of the international financial system. It also weakens the ability of European authorities to participate in managing the liquidity of international financial markets, and the stability of developing country external debt.

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Annex Acronyms

ACP	African, Carribean and Pacific Group of States
ASEAN	Association of Southeast Asia and Nations
BRIC	The Brazil, Russia, India and China group of emerging markets.
CIC	China Investment Corporation
DEVCO	European Commission department EuropeAid - Development and Cooperation
DFID	Department for International Development
DSF	Debt Sustainability Framework
EAP	East Asia and Pacific
ECA	Europe and Central Asia
EDF	European Development Fund
EEAS	European External Action Service
EIB	European Investment Fund
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IF	Investment Facility
IFIs	International Financial Institutions
IWGSWF	International Working Group on Sovereign Wealth Funds
HIPC	The Heavily Indebted Poor Countries
LA	Latina America
LAC	Latin America and the Caribbean
MENA	Middle East and North Africa
MDG	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MFF	Multi Financing Framework
OCT	Overseas Countries and Territories
ODA	Overseas Development Assistance

OOF	Other Official Flows
PNG	Private Non-Guaranteed External Debt
PPG	Public and Publicly Guaranteed
SDGs	Sustainable Development Goals
SMEs	Small and Medium-Sized Enterprises
SWF	Sovereign Wealth Fund

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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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THE PARTNERS IN THE CONSORTIUM ARE:

Participant Number	Participant organisation name	Country
1 (Coordinator)	University of Leeds	UK
2	University of Siena	Italy
3	School of Oriental and African Studies	UK
4	Fondation Nationale des Sciences Politiques	France
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
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