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FINANCIALISATION, ECONOMY, SOCIETY AND SUSTAINABLE DEVELOPMENT

Research Brief #3

Financial Liberalisation, Capital Flows and the Developing World

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1. Introduction

This Research Brief #3 for Work Package #6 of the FESSUD project draws on three Working Papers that constituted the first part of the Work Package (Bonizzi, 2013; Tyson and McKinley, 2014; Bonizzi et al., 2015). The paper explores, both theoretically and empirically, the financial relationships between the developing and developed world.

2. Theoretical Background

In *The changing impact of finance of development*, Bonizzi (2013) summarises the theoretical literature, both orthodox and heterodox, regarding the impact of changes in the financial system on the economic development of developing and emerging markets over the last three decades. The paper provides an incisive background for the rest of the Work Package with the relationship between theoretical developments and empirical trends visible in later papers. What is most relevant to this brief is discussion surrounding capital account liberalisation but this was preceded – both historically and in the paper – by the debate over domestic financial liberalisation.

McKinnon (1973) and Shaw (1973) – central opponents of "financial repression" – 'ascribed the poor performance of investment and growth in developing countries to interest rate ceilings, high reserve requirements and quantitative restrictions in the credit allocation mechanism', essentially 'government restrictions on the banking system restrain the quantity and quality of investment' (Arestis and Sawyer, 2005, pp. 2, 6, 10). Both argued that the expansion of the real money stock leads to an expansion of investment and therefore

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growth and that in developing countries the real money stock was low because of low interest rates due to policies of financial repression and high inflation. The solution was financial liberalisation, in particular free-floating interest rates which would expand the monetary base and allow the efficient reallocation or resources. As a result, and in tandem with debt management difficulties, which culminated in the 1982 debt crisis, financial liberalisation gained prominence as part of development policy, actively promoted, for instance, by the IMF and World Bank as part of structural adjustment programmes.

The hypothesis is open to severe criticism, including: doubt over whether higher interest rates or financial liberalisation in general, actually increase savings with widespread agreement that the effects are at least ambiguous; that such liberalisation increases volatility and susceptibility to crisis; and that the financial liberalisation paradigm does not take account of market failures. Following this, pre-conditions for, and the sequencing of, successful implementation of financial liberalisation came to be emphasised. These include "good institutions", a limited role of government ownership, and "sound" macroeconomic policy. On the theoretical side, a new literature on financial development emerged as part of endogenous growth theory, giving a more comprehensive account of the how advances in financial intermediation can positively impact growth. In particular financial development was argued to increase the fraction of savings turned into investment; improve the efficient allocation, and thus productivity, of capital; and increase the savings rate. These, and acknowledgement of limited "market imperfections" and the need for "appropriate sequencing", were attempts to rescue the thesis that financial development drives growth, the evidence for which is, at best, highly contested.

Similar arguments were later made against controls on the free flow of capital between countries. Capital mobility would, it was argued, lead to a more efficient allocation of capital, allow risk diversification, and discipline domestic economies. Despite devastating financial crisis attributed to volatile and rapacious capital flows, the policy consensus supporting liberalisation remains, albeit with acknowledgement of financial market "imperfections", in particular moral hazard and "original sin".

This agenda has also been heavily critiqued with little robust casual evidence that financial integration boosts growth. Theoretically it has been argued that opening the capital account may not increase investment since it does not change domestic returns to capital, and may even reduce investment because of real exchange rate appreciation and increased volatility and susceptibility to rapid reversals in flows. Empirically, a positive relationship between capital flows, asset prices and exchange rates has emerged with flows dominating "real fundamentals" in establishing these prices.

Further, the nature of actual capital flows has contradicted neoclassical theory, with net flows on aggregate flowing from developing to developed economies, and when following to developing countries not to those with highest possible productivity gains and investment rates. Recently, the extraordinary build up of foreign exchange reserves has, in large part, driven this. All of this leads proponents of financial liberalisation to argue that, rather than direct benefits, there exists "collateral" benefits from liberalisation, for example financial development, the importation of "better" corporate governance, and positive benefits to macroeconomic policy. However, the evidence remains weak.

A long tradition of critical economic scholarship has shown how finance can bring instability, including Minsky's "financial instability hypothesis". What this literature shows is that rather than the presence of "market imperfections" there is an endogenous tendency towards crises. Capital account liberalisation is therefore criticised as favouring boom-bust cycles in emerging markets. This offers a critical explanation of why the finance-growth nexus appears so week in practice.

3. The nature of contemporary capital flows

Building empirically upon this theoretical base, Tyson and McKinley's paper *Financialization and the developing world: Mapping the issues* carefully traces the nature of aggregate capital flows. From the 1980s we have witnessed significant financial sector deepening in low-income, and lower- and upper- middle-income countries. In just the last 10 years credit from the banking sector in the latter group has risen from under 40% of GDP in 2004 to around 55% in 2012, with this dominated by Asia. Similarly, cross-border

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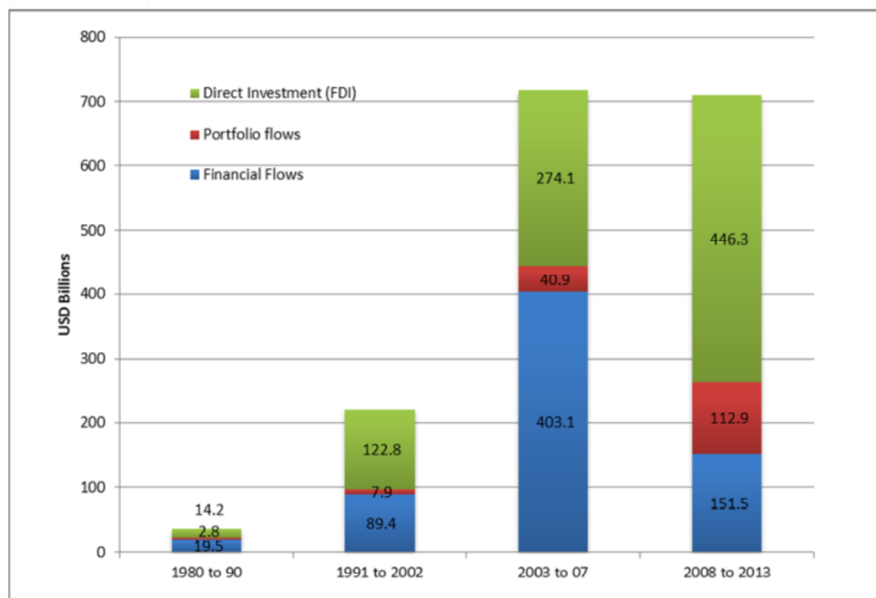
capital flows has increased enormously. As note already, the aggregated impact of these trends is less positive than proponents predict with an ambiguous relationship between financial liberalisation and growth and the likelihood of increased volatility and fragility.

Tyson and McKinley distinguish between foreign direct investment (FDI), portfolio flows composed of equity and bond flows, and financial flows primarily consisting of net bank lending, over four periods of financialisation. In addition to these they note the enormous growth of remittance to developing countries from negligible levels in 1980 to $518 billion in 2013. In 2012 these were nearly three times the level of ODA and larger than [net] private debt and [net] portfolio equity flows.

Figure 1 Average annual private capital flows to developing countries by type (1980 - 2013)



Source: Tyson and McKinley (2014, p. 20)

In the first period of financialisation, 1980 to 1990, private capital flows to developing countries were relatively small with banks in advanced economies risk adverse after the defaults of the early 1980s and neo-liberal liberalisation reforms more domestically focused. Flows, during this period, were also relatively stable. Between 1991 and 2002 a cyclical upswing in capital flows began driven primarily by FDI and bank lending, with the

former relatively stable and constituting 56% of total private sector capital flows. These FDI flows were heavily concentrated in Developing Asia and Latin American and the Caribbean, which, between 1991 and 2013, received 43% and 27% of FDI flows respectively. Bank lending made up 41% of total private sector flows and were far more volatile. They played a leading role in the 1997/8 East Asian crisis precipitated by 'excessive risk-taking and exuberance in financial markets, especially in asset and foreign exchange markets' (Tyson and McKinley, 2014, p. 22). By contrast Sub-Saharan Africa and Central and Eastern Europe did not participate in this "boom-bust" cycle over this period.

The third period, 2003 and 2007, was when financial flows peaked in developing countries. Over this period FDI trebled and financial flows rose from negative $30 billion in 2002 to positive $1.706 trillion in 2007. Some of these flows (mainly FDI) contributed towards increasing investment, particularly in China and India, but the increase in financial and portfolio flows created fragilities. Interestingly, this corresponded with a structural shift and the rise of South-South financing. For instance, between 2002 and 2012, 'nearly half of the financing for infrastructure in sub-Saharan Africa was financed by inter-regional governments and regional bodies' (Tyson and McKinley, 2014, p. 23). Finally, it was during this period that the holdings of international reserves truly skyrocketed, between 2000 and 2005 emerging market economies accumulated reserves at an annual rate of $250 billion or 3.5% of their annual combined GDP.

The line between the third and fourth periods is drawn by the global financial crisis, with the fourth period under study running from 2008 to 2013. During this period, capital flows were a key channel of transmission of the crisis from developed to developing countries, particularly middle-income countries (although trade and commodity prices were also important). FDI responded relatively little in contrast with other flows with least developed countries even seeing a rise in FDI and a shift in their destination from commodities towards infrastructure, manufacturing and services, as well as an increase in debt components relative to equity.

Bank lending on the other hand contracted sharply in response to the crisis falling from a peak of $853 billion in 2007 to a paltry $9 billion in 2008; subsequently bank lending has remained very volatile. Portfolio flows, which grew before the crisis, suffered a sharp contraction before recovering but remained very volatile. These flows reflected strong "push" factors in the advanced economies, such as quantitative easing and record low interest rates in these economies. The crisis impacted not only on flows but also on financial costs as debt spreads surged higher and liquidity deteriorated posing significant problems for developing countries and government financing in particular.

A number of key consequences emerge. First, the volatility of flows has increased significantly over driven, driven by financial flows. Second, FDI flows have been most robust in rapidly industrialising economics, such as China. Third, portfolio flows have been attracted by short-term opportunities for speculation in equity and bond markets and associated with asset-bubbles, particularly in real estate and stock markets, and financial crises. The scale of such flows, spurred by the rise of international institutional investors, is sometimes disproportionately large when contrasted with the relatively small size of recipient markets.

Interestingly, the impact of the financial crisis on developing countries was less than may have been expected, in part mitigated by the strengthening of balance sheets before the crisis and flows of international capital into these countries after the crisis in search of higher yields in the wake of counter-cyclical policy reactions. The crisis also brought with it a contradiction in international trade, equivalent to 8% of global GDP, and the end of the spectacular commodities boom that had run from 2004 to mid-2008, arguably reinforced by the growth in commodities as tradable assets. We see in this the link between financialisation and trade shocks, with this contraction in trade a crucial channel of transmission of the global financial crisis to the developing world.

4. External debt

Bonizzi et al. (2015), in *Developing countries' external debt and international financial integration*, zoom in on the issue of external debt which is also outlined by Tyson and

McKinley. The thesis of Bonizzi et al. (2015) is that traditional forms of vulnerability, particularly public sector over-indebtedness, have been superseded by vulnerabilities arising from increased financial integration, as outline by Tyson and McKinley. One key dimension of this has been the rise in external private credit. In developing countries the private sector accounted for 5% of total external debts in 1989, in 2012 this had surpassed 35%. The shift towards private sector debt is also seen in debt servicing, the majority of which, since 2007, has been private sector payments. Interestingly, increasing private external sector debt is partially due to debt-financing merger and acquisition activities in the process of emerging market companies transforming into multinationals, such as by Cemex in Mexico and Anglo-American corporation in South Africa.

The majority of this debt is held in East Asia and the Pacific (EAP), Latin America and the Caribbean (LAC) and Europe and Central Asia (ECA). In 2012 all regions external debt to GNI was within the 10% to 30% range, except for ECA that was close to 65%; LAC debt stocks have risen steeply since 2006. In all regions the majority of debt is long term in nature although short-term debt has increased since 2002, particularly for upper-middle income countries, and, since 2008, rapidly so in EAP where it is close to 50% of total external debt. Debt is also heavily concentrated amongst the top ten borrowers. Despite absolute growth, external debt stocks have fallen as a proportion of exports in all regions since the 1980s and 1990s and as a proportion of GNI (except for in ECA). Debt service costs have also fallen as a percentage of exports and as a proportion of government expenditure and revenue (in all but Europe). This indicates greater "debt sustainability".

This said, private external debt levels makes developing countries vulnerable in a number of ways. First, net factor income is negative for all regions showing that outward dividend and interest payments exceed inwards payments plus remittances. Second, in an era of cheap money over-indebtedness is still very possible, and in some cases the ultimate risk is born by the state – as a lender of last resort – but the gains accrue privately. Third, the rapid accumulation of external debt does not seem to arise out of the need to finance trade deficits but plays an increasingly important role in financing "shareholder value" oriented activity, such as merges and acquisitions. The decline in net indebtedness relative to GDP

should not therefore be viewed as counter to growing financialisation in developing countries.

5. Conclusion

This research brief has tied together three papers by focusing on the theoretical justifications for, and current dynamics of, capital account liberalisation and the resulting capital flows between the developed and developing worlds. It has highlighted key trends over the last three to four decades, the period during which financialisation took root, and explored in more depth the issue of growing external private debt. Capital flows remain a dominant feature of the global economy and developing countries continue to be caught in a subordinate position both by and vis-à-vis these flows; understanding this empirically and theoretically, and debating new forms of financial integration, remains a critical task.

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