

# Financialisation in Developing and Emerging Countries: A Survey

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## **Abstract**

This article attempts to summarise the growing literature on “financialisation” in developing and emerging countries. This will include the different theoretical and empirical works that have explicitly referred to the increasing role of finance in such countries as “financialisation”, as well as the recent developments in non-conventional approaches to finance and development. The article will cover the main theoretical approaches that have been used to explain the phenomenon, trying to set out what are the specific characteristics of the role of finance in such countries. It will then present an overview of the key empirical facts coming out of such literatures that are associated with “financialisation”, with respect to both the changing role of the domestic financial sector and the impact of external factors, with particular reference to capital account openness.

Keywords: Financialisation, Finance, Development

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## Introduction

The conventional theoretical and policy debates on the relationship between finance and development have focused heavily on the conjecture and assessment of a positive causal relation between the former and the latter<sup>1</sup>. Such an analysis, while bringing finance to the fore, does not however move much beyond a standard neoclassical analysis: financial markets are assessed in terms of their importance and efficiency in supplying their service to the economy, i.e. how much and how well they channel saving to investment.

Alternative schools of thought present a more complex view of the relation between finance and the “real economy”. Some of the most prominent “heterodox” traditions, such as Post-Keynesian, Institutional, Marxian and Regulationist schools of economics and political economy, have paid attention to the rise of finance in the economy, by pointing out its historical evolution and its consequences. Many have referred to this rise as “financialisation”, which has been over the past few years the subject of a rapidly developing literature. Most of the literature has assessed the impact of an evolving financial sector on advanced economies. However, some contributions focus on the peculiar features of financialisation in developing and emerging economies.

The literature on financialisation on developing countries is relatively new,

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<sup>1</sup> Paradigmatic of such approach is the concept of “financial development” (see, for instance, King and Levine, 1993; Levine, 1997).

and to the best knowledge of the author, a systematic review of it does not yet exist. This is the purpose of the article. The first section will analyse the conceptual issues about financialisation in developing countries, particularly its role in the evolution of the political economy of such countries. The second section will provide an overview of the key empirical facts that have been associated with financialisation in developing countries. The third section will deal with the international aspects of financialisation, such as capital flows cycles and financial integration. The fourth section concludes by providing a systematic overview of the considered themes.

## **1. Financialisation in the Political Economy of Developing Countries**

Financialisation is almost everywhere defined in the words of Epstein, (2005, p. 1) as:

“the increasing importance of financial markets, financial motives, financial institutions, and financial elites in the operation of the economy and its governing institutions, both at the national and international levels”.

This very broad definition has allowed many different theoretical approaches to address the issue. In the context of developing countries, the different theoretical frameworks more or less fit within the schools of thought of the Theory of the Regulation, Marxist political economy or post-Keynesian economics. Of course the boundaries are sometimes blurred since, for

example, the regulationist school has much in common with both Marxist and post-Keynesian concepts. However, the approaches often emphasise different aspects and conceptualisation of the process of financialisation.

The school of thought that has first addressed the specificity of developing countries in their path towards financialization is the regulationist school. More or less explicitly, authors seek to explain different aspects of a “financialised regime of accumulation”. Much like the move from “Fordist” to finance-led patterns of accumulation that occurred in many advanced economies (e.g. Boyer, 2000), many developing countries have experience a shift from different forms of “peripheral Fordism” to locally-specific forms of financialisation of their economy (Becker et al., 2010).

A key element of regulationist theories is that a regime of accumulation needs a “mode of regulation”, a set of institutions and policies, to make the economic and social reproduction feasible. Therefore the policy shifts that occurred in developing countries in parallel to their increasing financialisation are a central focus of the analysis. Since the late 1970s, many developing countries have followed the policy advices of proponents of financial liberalisation and financial development. Moreover these policies fit into the broader context of the transition in economic policy towards more market-friendly development strategies and a shift in macroeconomic policies, propagated by the World Bank and the IMF during the Washington Consensus era. These changes have deeply affected the role of the financial sector in the economy and the political economy of these countries.

Financialisation is therefore not a linear process and assumes different

forms in developing countries vis-à-vis advanced economies, as well as country-specific forms. A first big distinction, which is made by Becker et al., (2010, p. 228), is “financialization between the take-off of a second circuit of ... securities, and financialization based on interest-bearing capital and, thus, on high interest rates”. The first type of financialisation, which has its core in the inflation of financial assets price, is the most common form in advanced Anglo-Saxon countries. However financialization through interest income may be of particular relevance for many developing countries, since inflation and the need to encourage capital inflows (or discourage capital flights) has often induced these countries to adopt high-interest rates policies.

Post-Keynesian approaches points to the rise of financial profits and incomes as one of the key processes of financialisation (Stockhammer, 2004). In the context of emerging markets, Demir (2007) points to the rise of “rentier” capitalism, primarily through the financialisation of firms’ income, and its negative consequences for productive investment and growth. There is, however, a distinctive lack of explicitly post-Keynesian theoretical literature on the issue of financialisation in developing countries.

Marxist accounts of financialisation emphasise similar aspects. Ashman et al. (2011) situate the process of financialisation in Marx’s distinction between interest-bearing versus other forms of capital, and between the accumulation of real versus fictitious capital.

“The neoliberal period has witnessed both the subordination of real accumulation to fictitious capital – with the expansion of speculative assets at the expense of real investment – and the integration of real accumulation into

the realm of interest-bearing capital, resulting in financialised accumulation of a systemic nature.” (Ashman et al. 2011: 176)

Ideological and policy shifts that empower private capital, such as privatisation and the deterioration of public provision of services and goods, have further strengthened the power of finance over the economy and the social and political structure of developing countries. Neoliberalism is therefore tightly linked to financialisation (Fine, 2010), although perhaps by coincidence of interests rather than necessarily by explicit design.

Also includible within the tradition of Marxist political economy is Jeff Powell’s concept of “subordinate financialisation” (Powell, 2013), which refers to the Marxist concepts of imperialism. The distinctiveness of financialisation in peripheral countries is its subordinate nature, i.e. the extent to which it is “shaped by imperial relations between states” (Powell, 2013: 3). Thus peripheral countries are subject to similar shifts experienced by core countries, but at the same times these are mediated by their subordinate position, which shapes the form in which financialisation takes place. For example, the global shift to market-based finance by firms, in peripheral countries presents the additional feature of firms turning “disproportionately to foreign capital, allowing the extraction of a share of the domestically-generated surplus” (Powell, 2013: 19)

Marxist approaches, however, differ markedly from both Post-Keyensian and regulationist approaches in their emphasis on power and class relations. As Marois (2011) argues, there is a need to move beyond institutions and policy and uncover the underlying structural political dimensions. This leads Marxist

scholars to refute the concept of a “rentier class”. As Ashman et al. (2011) argue, the shift of the balance of power from labour to capital and from real to interest-bearing capitalists is different from arguing that financialisation simply marks the return of the rentier.

These disagreements are reflected by the different emphases that these approaches put in the historical accounts of the rise of financialisation. For those who work within a regulationist framework, it is central to evaluate the evolution of the “monetary and financial regime”, in relation to the rise of finance-led accumulation regimes. The case of Brazil is paradigmatic in this sense. While the country implemented Washington Consensus policies more slowly and partially than other Latin American countries, already in the 1980s the country’s monetary and financial regime were conducive of a peculiar kind of financialization based on a dual-currency system. Alongside the state-issued currency that was continuously eroded by inflation, an alternative currency, endogenously issued by the financial sector backed by public debt and indexed to inflation, allowed the accumulation of wealth by private financial institutions (Araújo et al., 2012; Paulani, 2010). When policies of privatisation and liberalisation as well as commitments to monetary and price stability came about in the early 1990s, financial accumulation was primarily driven by very high interest rates<sup>2</sup>. The expansion of internally held public debt, also due to state intervention to counteract the 1999 financial crisis, marks the internal financialisation of the country, with a redistribution of income from the middle-class towards financial capital (Becker et al., 2010).

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<sup>2</sup> Araújo et al. (2012) calculate that holding government bills at the Selic rate from January 1991 to January 1999 increased the capital sevenfold.

Similar experiences, where the shifts in the mode of regulation promoted financialisation, have been shared by other countries. The experience of Mexico has been one of recurrent financial crises followed by state intervention in favour of the financial sector, coupled with high-interest rates and economic policies that slowly moved the economy towards a finance-led regime (Correa et al., 2012). Indeed, contrary to Brazil, Mexico followed more closely the policy suggestions of the Washington Consensus in the field of financial liberalisation. The banking sector, for instance, was extensively privatised and opened to foreign competition, whereas in Brazil state-owned banks and, in particular, the development bank BNDES, continue to play an important role within the domestic financial sector.

The importance of post-crisis IMF-led reforms towards financial liberalisation has been typical of East-Asian countries as well. In South Korea, a vast program of banking and financial liberalisation was undertaken in the aftermath of the East Asian financial crisis (Crotty and Lee, 2002; Kalinowski and Cho, 2009). In Malaysia, the move towards financialisation has also been propelled by policies after the 1998 crisis, but these were of a more “selective” scope: as Rethel (2010) argues, “the state remained the gatekeeper of Malaysian capitalism”, in actively promoting some financial practices that drove the economy to a more finance-led accumulation regime. The role of the State within the country’s political economy during the financialisation process thus remains a key variable of analysis.

Marxist scholars emphasise the more structural global and national economic factors. The rise of financialisation is both the result of national

shifts of class power towards capital in general and financial capital in particular. Therefore Marxist scholars have sought to assess what processes may lead to such political shifts. In developing countries, as Ashman et al. (2011: 189) “there is the added twist of both creating financial elites and strengthening their roles.” Such creation may intertwine with other political objectives, such as the creation of a black political elite in South Africa (Ashman et al., 2011) or a local-Malay entrepreneurial class in Malaysia (Rethel, 2010).

Another factor affecting the balance of political power towards finance has been the recurrence of financial crises. As Marois (2011) argues, the recoveries from the crisis in Mexico and Turkey have reinforced the leading role of finance and banking interests in the national political economy. Global factors also play a key role. Indeed some Marxist scholars have explicitly argued that the rise of financialisation in developing countries is the result of the international power of the US, principally through the rise of the US dollar as a quasi world currency (Painceira, 2009; Lapavitsas, 2009). This view is also taken up by Powell (2013), who considers this an important element shaping the subordinate character of financialisation in peripheral countries. These themes will be discussed in section 3.

## **2. Financialisation in Developing Countries: Key**

### **Empirical Facts**

Several authors have pointed to different empirical facts associated with

financialisation. These can be grouped into changes affecting the main sectors of the economy, firms, households and banks, as well as some peculiar trends within developing countries, such as the expansion of foreign banks, microfinance, and the financialisation of commodity markets.

A first key theme is the implication of financialisation for non-financial firms' investment. A common observation is that firms increasingly engage in financial rather than productive investment. This a key research issue in the work of Firat Demir (Demir, 2007; Demir, 2009a; Demir, 2009b): using micro-level data for Argentinean, Mexican and Turkish firms, he finds that policies of financial liberalisation do not significantly contribute to reduce capital market imperfections, while on the other hand the availability of financial investment as well as the differential return between financial and non-financial investment have a negative effect on productive investment and a positive effect on financial investment. The increasing importance of financial activities, including derivatives speculation, for non-financial corporations is testified by several different studies (Correa et al., 2012; Farhi and Borghi, 2009; Rossi, 2011). Additionally, firms' productive investment may be reduced as a result of the increasing attention to the creation of "shareholder value". As a result of financial liberalisation in South Korea, "the pressure from foreign and domestic financial investors led to costly efforts by Korean corporations to increase shareholder value and to defend themselves against possible hostile takeovers, which impeded productive investment." (Kalinowski and Cho 2009: 28). Moreover there is evidence that shareholder orientation in South Korea has decreased not only productive investment but also investment in

Research and Development, with potentially more damaging long-term effects (Seo et al., 2012). Karwowski (2012) presents evidence that South African firms are “over-capitalised”, that is they hold financial assets way in excess of what they need for their productive activities, so that firms have become the largest holders of bank deposits.

At the macro-level the combined availability of high-return short-term financial investments and the pressure from financial investors have led in many developing countries to a reduction in productive investments, which have fallen as a share of GDP (Araújo et al., 2012; Demir, 2009b; Kalinowski and Cho, 2009; Shin, 2012; Tan, 2013). Furthermore, figures for Brazil suggest that the actual drop in manufacturing within the non-corporate sector is even higher, as manufacturing contribution to GDP dropped by 50% since 1980, while lower-quality and natural-resource intensive activities have grown at the expense of labour-intensive production (Araújo et al., 2012). This clearly has negative impacts for employment and wages. In Mexico, for instance, real minimum wages have declined constantly since the 1980s so that half of the working force is now working in the informal sector (Correa et al., 2012). Furthermore it has reinforced income inequality, where richer families that can obtain financially related income have seen an increase in earnings in spite of the downward trend in wages. Similarly, in South Korea, since the late 1990s about half of the working force is employed with contracts lasting one year or less (Kalinowski and Cho, 2009). In this sense, as Araújo et al. (2012) argue, “financialization becomes an even bigger structural obstacle, since it causes functional re-concentration of incomes in favour of

the holders of capital without necessarily inducing them to raise the level of productive investment, a basic factor in the generation of employment and income” (p. 23).

Changes in the financial sector itself also constitute a central theme of the financialisation literature. A transition to more market-based financial systems is a theme for many countries that traditionally relied on more or less directed-credit through the banking sector. While, as previously mentioned, in the case of Brazil financialisation is generally understood to have expanded by leading to the rise of high-interest rate “rents”, in Asian countries the expansion of capital markets may signal financialisation through asset prices (i.e. “fictitious capital” according to the terminology of Becker et al. (2010)). Lee (2012) finds that the expansion of financialisation in East-Asia can be seen in the rise of three patterns: the expansion of stock-markets, fuelled by regional integration and capital account liberalisation; the changing role of banks, which now engage in different kinds of activities, such as securitisation, trading and insurance; the rise of institutional investors, especially mutual funds and sovereign wealth funds. Rethel (2010) further specifies some of these patterns for the case of Malaysia. Policy efforts were aimed at developing local capital markets, especially bond markets, which poses a challenge in terms of credit allocation, since “the expansion of bond finance further entrenches a two-tiered industrial structure in Malaysia, which privileges bigger corporations, often linked to the government, to the disadvantage of SMEs” that do not have access to capital markets (Rethel 2010: 496). At the same time banks have reoriented their activities towards trading and fee-

generating business. Paradigmatic is the case of Cagmas, a state-led financial institution set up to facilitate the availability of affordable housing, which slowly turned into the biggest securitization provider in the country.

Banks also reoriented their business by allocating an increasing proportion of credit to households. Examples of studies testifying this phenomenon are Ergunes (2009) for the Case of Turkey, Chang (2010) and Cho (2010) for South Korea, Rethel (2010) for Malaysia, dos Santos, (2011; 2013) and Paineira (2012) for Brazil, dos Santos, (2011; 2013) for Mexico, Turkey and Poland, Becker et al. (2010) for Slovakia, Ashman et al. (2011) and Karwowski (2012) for South Africa and Gabor (2010) for Eastern Europe. All these studies document that credit to household expanded quite dramatically over the past decade, often from very low or negligible levels.

A very important development in the financial sector is the expansion of foreign banks into the domestic market. The policy push above reviewed was, in general successful, so that in many countries foreign banks have come to occupy an important place in the domestic financial sector. Several studies reveal that foreign banks have come to play a substantial and in some cases a leading role in Mexico (Correa et al., 2012), Turkey (Ergunes, 2009), Eastern Europe (Cetkovic, 2011), South Korea (Cho, 2010), Philippines Mexico and Brazil (Lapavitsas and dos Santos, 2008). In a couple of works considering the issue, dos Santos highlights evidence suggesting that foreign banks are often key agencies in transmitting “financialised” practices, i.e. they obtain high profits through non-credit activities, such as trading and fees and commissions, as well as through aggressive household lending. In Brazil and

Mexico, for example, foreign banks have led the way in driving the expansion of credit card lending and mortgages, with other banks quickly adapting to the new tendencies (dos Santos, 2011; 2013). Analogous trends can be found in South Korea (Cho, 2010). In Eastern Europe foreign banks have taken the lead in the expansion of foreign currency household loans and the rise of speculative activities (dos Santos, 2011; Gabor, 2010). Additionally, foreign banks have been critical in channelling the effects of the global financial crisis into emerging markets. Foreign banks were at the core of the increasing borrowing from abroad in South Korea during the pre-crisis years, generating substantial external vulnerabilities that turned into serious financial distress during the crisis (Cho, 2010). In Mexico, on the other hand, foreign banks responded to the crisis in the US by repatriating profits to cover losses, and further reducing credit availability, thus directly contributing to the transmission of the crisis (Correa et al., 2012).

The changes of the financial sector had consequences for households' income, a growing proportion of which is used to repay interest on loans. In Turkey, for example, household-debt to income increased from 7.5 % in 2002 to 29.5% in 2007, while interest payments as a percentage of income increased from 2.1% to 4.6% in the same period (Ergunes, 2009). As a result, the cyclical expansions and contractions of household credit often created an additional layer of financial instability as well as an additional channel for crisis transmission. For example, in South Korea a credit card boom that eventually burst in 2003 resulted in widespread defaults of households and, in turn, financial institutions, which were bailed out by the State (Chang, 2010). In

South Africa, a consequence of the American sub-prime crisis was a domestic credit crunch, that resulted in widespread defaults and the repossessions of both real estate and automobiles (Ashman et al., 2011).

In some countries the expansion of household debt had a very important “functional” role, in the management of the business cycle, much like it had within Anglo-Saxon capitalism. In Slovakia, for example, the expansion of household debt over the past decade has sustained aggregate demand in a situation of low wages (Becker et al., 2010). Similarly, in Malaysia credit to households was a central element in the government efforts to promote a consumption-led recovery after the 1998 crisis (Rethel, 2010). Moreover, household lending becomes a key mechanism in social reproduction: “never has access to finance been so decisive for both social mobility and entrepreneurial success. Indeed, credit has become increasingly important to access basic public goods such as education and health care” (Rethel 2010: 498). Unequal access to credit can thus exacerbate existing social and economic inequalities.

In addition to the expansion of household lending, “mass-based financialisation” has also resulted in the increasing participation of (especially middle-class) households into the active managements of their financial and housing assets. This issue seems to be particularly relevant for East Asia, where the post-crisis reforms pushed those countries towards a more “Anglo-Saxon” type of financial system. The documented expansion of institutional investors in East Asia is an aspect of this (Lee, 2012). Once again the metamorphosis of existing Malaysian institutions into channels of

financialisation stands out as a paradigmatic case (Rethel, 2010). Investment trusts, which were originally implemented as a vehicle to spread diffused ownership within the local Malay population (*bumiputeras*) as part of the policies to promote the rise of a local entrepreneurial class, have become the primary institutional investors in the country, aside from state pension funds. The gradual opening to non-*bumiputeras* as well as the diversification into different asset types indicates the shift in intentions of these funds “from a concern with the (ethnic) redistribution of corporate ownership to a more general mandate to promote portfolio investment and to inculcate a (low risk) investment culture that draws more and more people into the market.” (Rethel 2010: 502).

Housing and real estate have risen in many countries, a fact that is often the counterpart of the increasing household debt. In South Africa, for example, property prices increased by 389% between 1997 and 2008 (Ashman et al., 2011). In South Korea the extension of credit to households after the credit card bubble in 2003 was predominantly in the form of mortgages, sustained by a steady increase in house prices (Chang, 2010; Cho, 2010). The already mentioned Cagmas in Malaysia has been at the centre of the parallel expansion of homeownership and mortgages, as well as a securitisation provider, all of which is clearly reminiscent of the renowned US institutions Fannie Mae and Freddie Mac (Rethel, 2010).

Social policy reforms are however not confined to countries that actively pursued (indebted) consumption-led strategies. The penetration of finance into an ampler range of social policy is in this sense a global trajectory that

goes somewhat beyond pure economic policies. Privatisation of pensions and insurance, for instance, has occurred in Mexico (Correa et al., 2012). Perhaps the most famous case is that of Chile, which was a pioneer in privatising its retirement system through the creation of pension funds. Such schemes have provided a very direct way in which finance has penetrated the life of many Chileans. First of all, the very highly concentrated sector, both in terms of ownership – often by foreign financial institutions – and in terms of investment, has over its whole existence proved to be very costly for pensioners, with about one third of contributions kept by fund management and owners in fees and commissions (Sumaria, 2010). Moreover, the financial crisis has put a lot of stress on the funds, so that old-age income security is at risk, which has led to pension reforms by the Chilean government (Riesco, 2009).

Even amongst the poorer strata of society, financialisation makes its way through the expansion of microfinance. Microfinance itself has been increasingly “financialised” by linking in to the global capital markets. According to Aitken (2010), microfinance “has recently become a site of financialization, that is an object transformed into an ‘investable asset’ capable of generating financial profits for investors” (p. 230). This refers to the rise of microfinance investment funds (MIFs), through which it is possible to invest in institutions directly providing micro-credit, or, more commonly to purchase a securitised microloan-backed asset (Aitken, 2013). Such funds have attracted a rising amount of flows from investors, initially as “socially-concerned investments”, but subsequently these turned into purely financially

driven allocations (Tyson, 2011). In fact, such funds are seen as a way to diversify portfolios, since MIFs present low correlations with other assets (Aitken, 2010). In this context it is not surprising to see a shift in microfinance practices towards commercialisation, as Tyson (2012) documents: firstly, the growth of microfinance has been remarkable<sup>3</sup>; secondly, microfinance institutions themselves have changed nature, as the sector is becoming dominated by regulated fully-fledged financial institutions as opposed to NGOs and credit-unions; thirdly, the activities of microfinance institutions have moved away from credit for investment in productive activities towards consumption lending and other financial services, and away from group lending to individual lending. These moves made microfinance extremely profitable, so that vast investments poured into MFIs. As a result, microfinance institutions actively turned themselves into financial institutions through IPOs such as the one of the renowned institution Compartamos in Mexico, which was vastly oversubscribed (Aitken, 2010; Aitken, 2013). Such processes, while making microfinance more self-sustainable, have made it highly unstable and destabilising. In India the high potential yield have essentially generated a bubble-like phenomenon of expansion and contraction as soon as the first defaults set in (Wichterich, 2012). Additionally, the aggressive credit extension have generated situations of over-indebtedness and serious financial distress, to the extent that it generated over 200 thousands suicide among farmers (Wichterich, 2012). Even where situations are less tragic, it seems that microfinance, as a result of growing

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<sup>3</sup> For example, the number of microfinance institutions grew from 618 in 1998 to 3,552 in 2008.

financialisation, fails to alleviate poverty substantially.

Finally, financialisation has affected developing countries indirectly, through its impact on commodities. Commodity prices have exhibited a typical boom-bust trajectory over the 2002-2007 period (Akyüz, 2012). There is considerable evidence that such price instability was driven by financial investors, who rapidly included commodity futures and even “real” commodities as an asset class into their portfolio, attracted by their low return correlation with the standard financial assets (Wray, 2008; Tang and Xiong, 2010; Ventimiglia, 2012). The impacts of such cycles affected developing countries considerably. Despite their positive effect on the current account of commodity exporters, they have generated some sort of “Dutch disease” phenomenon where production and investment in commodity sectors crowd out investment in other sectors (Araújo et al., 2012; Nissanke, 2010). Moreover, as Newman (2009) reports for the case of coffee, the increasing financialisation of commodities may reinforce the already existing inequalities in the production chain.

In conclusion, the literature on financialisation and development is extremely vast and wide-ranging. The themes considered so far refer to the “domestic” aspects of financialisation of developing and emerging countries. However in many cases, the literature refers to the issues of capital account liberalisation and its consequences for capital flows and exchange rates as a key theme for financialisation. The aspects of “international financialisation” deserve further treatment and will be considered in the next two sections.

### 3. Critical Views on Financial Globalisation

Alongside the development of the consensus views on financial globalisation<sup>4</sup>, the heterodox traditions of economics have also assessed capital flows and their impact on emerging and developing economies. This section will review such contributions by firstly looking at models of Minskyan boom-bust cycles in the context of emerging markets crisis. It will proceed to analyse the heterodox criticisms of the mainstream foreign capital-growth nexus, and present alternative views. Then it will analyse the implication of such alternative theories for global imbalances and the rise of foreign exchange reserves. Finally, it will look at the theory of currency hierarchies and its relation to capital flows.

Much as in the mainstream, a first line of inquiry has sought to analyse emerging markets currency and financial crises, following the events in the late 1990s. The typical “boom and bust” dynamics of such crises, coupled with the progressive deterioration of balance sheets makes Hyman Minsky’s “financial instability hypothesis” (FIH) a particularly suitable framework of analysis. The literature applying the FIH in the context of emerging markets crises is extremely vast (Taylor, 1998; Kregel, 1998; Palma, 1998; Dymski, 1999; De Paula and Alves, 2000; Arestis and Glickman, 2002; Schroeder, 2002; Grabel, 2003; Cruz et al., 2006; Onaran, 2007; Frenkel and Rapetti, 2009). All these papers present a similar story of the emerging countries crisis, where capital flows are an additional element of financial instability.

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<sup>4</sup> See, for instance, Kose et al. (2006) for a wide-ranging review.

Domestic financial liberalisation reforms, which usually precede the beginning of a boom phase, have the effect of rising interest rates and generally making domestic returns attractive for investors. Once the capital account is liberalised, the high interest spread induces both domestic and foreign players to finance themselves in foreign currency to invest in domestic currency assets. As capital flows grow, the liquidity in financial markets flourishes and asset prices increase, which in turn attract more capital flows in a positive-feedback fashion. At the same time capital flows appreciate the real-exchange rate, which slowly deteriorate the country's current account and external financial position. The boom also starts to make the balance sheets of many economic units in the country more and more fragile. Awareness of the country's deteriorating fundamentals and currency overvaluation spreads, and investors start to limit their exposures. This in turn slows the boom, which further deteriorates the financial structure of more economic units. At some point, either a domestic economic event – such as the failure of a major financial institution – or policy shock – such as the sudden relinquishment of an exchange rate peg by the central bank – or the decision of foreign investors to speculate against the currency, spreads the panic: capital flows suddenly stop and turn negative. Financial fragility becomes a widespread financial crash as the currency depreciates, generating extremely serious issues for all borrowers in foreign currencies, and in turn for the whole economy.

These views present a powerful narrative against the predominant “moral hazard” view of the crisis of emerging countries. As Palma (1998) claims,

“over-lending” and “over-borrowing” may be reinforced by distortions in incentives and regulations, but they are essentially endogenous components of a free-market economy. The endogenous character of the crisis is presented as the key distinguishing element of Minskyan approaches to emerging markets crises vis-à-vis standard approaches. Arestis and Glickman (2002) vividly makes this point:

“[...] whilst there may be some common ground, the differences are crucial. The most striking of these relates to the question of whether the source of the Asian crisis was endogenous or exogenous and the related issue of the coincidence or otherwise of financial liberalisation and financial crisis. A further crucial difference is that whilst [the conventional views] hold one group of actors or another, lenders borrowers or the authorities, our Minskyan thesis incorporates all of them into an endogenous interpretation of the crisis. We may conclude therefore that ours is a more general approach.” Arestis and Glickman (2002: 255)

Capital account liberalisation is therefore criticised as a policy move that favours the rise of a boom-bust cycle in emerging countries. And conversely, capital account management is advocated as a way to avoid or limit the effects of the crises<sup>5</sup>.

The heterodox criticism towards free capital movements was, however, not only confined within the issue of financial crises. The conventional understanding of the finance-growth nexus, upon which all the various strands of financial liberalisation policies are based upon, was criticised heavily by

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<sup>5</sup> See Grabel (2003) for a comprehensive review and assesment of such policy proposals.

Nissanke and Stein (2003). The authors consider these views, according to which the financial system is there to channel funds from units in deficits to units in surplus and any problems arising within it are due to various form of informational problems, as static and impoverished. They contrast them with a view, based on the works of Keynes, Minsky and Schumpeter, where finance is a central component of capitalist accumulation and endogenously creates the potential for instability, since uncertainty is pervasive and generates systemic risks, as opposed to idiosyncratic risks created by moral hazard. Therefore, instead of adopting a “plumbing” approach that simply aims to correct the distortions of an otherwise sound system, countries should seek to reform the “architecture” of their financial system. This entails a vast reorientation of institutions that together enable financial circuits to better intersect with circuits of production, in direct contrast to policies of financial and capital account liberalisation, which favoured short-term profits orientation and risk-taking in financial markets and discouraged productive investment.

In this sense the traditional balance of payment distinctions between debt and direct investment flows becomes less important, as no type of capital flows necessarily ends up in the productive side of the economy. Indeed, some authors have argued that FDI, which even critics of financial globalisation, such as Stiglitz (2000) considered positively, can be as ineffective to spur growth and just as dangerous forms of external exposure as short-term capital flows (Singh, 2003).

A systematic theoretical critique of the foreign capital-growth link was made by Bresser-Pereira, 2002 and Bresser-Pereira and Gala (2009) and in a very

recent paper by Arestis and Resende (2013). Running a current account deficit does not bring an acceleration of accumulation, since in general it will appreciate the real exchange rate, increasing income and domestic consumption. In this sense foreign saving will simply replace the decline of domestic saving, and foreign debt is essentially financing consumption rather than investment. Only if investment opportunities make the marginal propensity to consume fall, will income from foreign capital flows be spent in investment, and thus contribute to a sustainable high-growth pattern. This condition is found to be rare though, such that the low growth of Brazil since the 1990s is attributed precisely to the policy shift in favour of a foreign-savings growth strategy (Bresser-Pereira, 2002).

This argument is very similar to the critique of financial globalisation by Rodrik and Subramanian (2009), on the basis of the investment-constraint vs saving-constraint argument. An important difference though is that Rodrik and Subramanian's analysis is based on a loanable funds model: in the saving-constrained economy, capital flows increase the supply of "investable resources", thereby reducing the interest rate and spurring investment. Developing countries are investment-constrained not because of a fundamental demand-constraint on growth, but because there are some institutional weaknesses or because there are large learning externalities in investment. To the contrary, the primary purpose of Arestis and Resende (2013) is to show that the FISF (finance-investment-saving-finance) circuit, which relies on the traditional Keynesian proposition that investment drives saving is valid even in the open-economy. In open-economy with non zero-

elasticity of import and export to the exchange rate, when the exchange rate appreciates, exports decrease and imports increase. If domestic investment – i.e. the demand for capital goods - stays at the same level, there will be at least a partial part of capital goods imported that is not matched by exports. This gap, which mirrors the current account deficit, increases saving in the other country. Investment therefore determines saving even in the open economy but it may not necessarily generate domestic saving: it may generate saving abroad. The real exchange rate becomes in this sense a distributional variable between domestic and foreign saving.

Indeed a criticism that applies to the conventional approaches to financial globalisation is their reliance on loanable funds theory. Real interest rates at the global level are assumed to be determined as the equilibrium between the global supply and demand for loanable funds (Perraton, 2012). In a very influential paper Borio and Disyatat (2011) criticise the conventional excess savings view of global imbalances. They argue that such view confuses saving, which is unspent income, with financing, a cash-flow concept indicating a flow of funds. In the open-economy context this is reflected by confusion between net and gross flows: net flows are simply the financial counterpart of trade and income factors, while gross flows are all flows of funds moving across borders. Current account data do not necessarily provide any indication of how investment is financed, nor is it conversely warranted to connect any specific gross flow to the current account.

Bibow (2010) makes a very similar point in his criticism of global imbalances:

“Simply put, in the context of monetary production economies the supposed

excess saving (or: saving glut) can only arise together with the corresponding excess spending being done by someone else, somewhere.” (Bibow 2010: 6)

Such excess spending arose in the US, which experienced a consumer-led boom, driven by the expansion of private credit, especially in the form of mortgages. These phenomena have been fuelled by financial innovation and encouraged by the expansionary monetary policy of the Federal Reserve. The resulting “global dollar glut” spilled over to other countries. Most of it, however, returned to the US in the form of reserves accumulation.

In another article, Bibow (2008) considers the desirability of such arrangements from the point of view of developing countries. While undoubtedly this accumulation has costs and may be sometimes related to some form of mercantilist strategy, it raises more fundamental doubts about capital account openness. Notwithstanding the weak relations between foreign capital flows and growth, the current pattern of these flows, which are simply recycled into low yield US assets, is of little benefit for these countries. While this seems somewhat preferable to the risky building up of current account deficits that preceded the late 1990s crises, it is nonetheless a very distorted system, where developing countries essentially play the role of providers of high return assets for foreign rentiers. It is preferable in this sense to have a comprehensive system of capital account management. Even the supposed “collateral benefits” could be achieved by allowing only a selective range of long-term capital flows that match the needs of the country, and importing selective services that could improve the efficiency of the country.

The accumulation of foreign exchange reserves is the focus of scholars

working in the Marxist political economy tradition (Painceira, 2009; Lapavitsas, 2009). Developing countries in the era of financialisation have accumulated vast reserves, either to maintain their trade competitiveness or to shield themselves from financial crises. The role of the US dollar as a “quasi-world money”, that is the ultimate means of payment to settle international transactions, makes the purchase of safe US public debt securities the easiest way to accumulate reserves. The rise of the US dollar has also been fostered by the changes in the “world market”, i.e. the rapid expansion of internationalised circuits of production and trade. The need of multinational corporations to engage in international financial transactions have boosted international capital and money market and reinforced the role of the US dollars as (Powell, 2013).

These analyses underline the exploitative character of such international arrangements:

“Issuing quasi-world-money has become an international mechanism for the rich to extract value from the poor in the context of financialisation and free capital flows. In this sense, reserve accumulation is an exploitative process, a form of tribute accruing passively to the issuer of quasi-world money.” (Painceira, 2009: 21).

Reserve accumulation is also seen as a key channel of transmission between international finance and domestic financialisation. The central banks operations pertaining to reserve accumulation and subsequent sterilisation have created a pool of domestic liquidity for domestic banks, which enabled the expansion of their balance sheets (Painceira, 2010; Painceira, 2012).

Gabor (2010) analyses the situation of Eastern European countries, and highlights the role of central banks sterilisation bonds in creating the pool of liquidity that banks used to engage in a range of risky (such as foreign currency lending to households) or effectively speculative activities (including carry trade and currency arbitrage). This situation made the central banks actions to address the post-2008 crisis more difficult, since liquidity provision could have the conflicting effects of providing relief to the financial system and creating incentives for currency speculations in an already unstable environment.

Furthermore, the new configuration of financial globalisation, with more sound “fundamentals” and reserve accumulation by emerging markets, does not seem to have reduced the cyclicity of capital flows. As Akyüz (2012) shows, since 2002 the positive relation between capital flows, asset prices and exchange rates in emerging markets has kept intact, with an even closer co-movement across different countries. Equity markets boomed and real exchange rates vis-à-vis the dollar appreciated considerably between 2000 and 2008 and crashed together in the aftermath of the Lehman Brothers collapse, only to recover in a new boom since 2009. The much more solid structure of these economies, such as the current account surpluses or small deficits, “sound” fiscal situations, the much smaller incidence of currency mismatches and substantial levels of foreign exchange reserves, has avoided the catastrophic consequences of previous crises, but could not prevent the sudden stop in capital flows, asset price deflation and sharp currency devaluation.

Brazil's situation during the crisis is emblematic. As Kaltenbrunner (2010) and Paineira and Kaltenbrunner (2009) show, despite solid fundamentals the country experienced one of the world's largest currency depreciation. The rapid integration of the country has made the Brazilian Real one of the most traded emerging currencies, turning it into a financial asset itself. The external vulnerabilities, given by a large stock of liabilities to foreign investors, were critical in determining the seriousness of the crisis. In this sense capital flows themselves, regardless of their precise form, create a vulnerability to foreign-driven shocks.

The underlying reasons for this can be found in the theory of currency hierarchies (Terzi, 2005; Kaltenbrunner, 2011; Andrade and Prates, 2013). Accordingly, exchange rates can be understood on the basis of Keynes' theory of the own rate of interest: internationally each currency has a different liquidity premium, based on its role in the international financial system. This points to a hierarchy between currencies that have a higher liquidity premium, with currencies that have lower liquidity premia having to compensate with higher returns. A currency's position in the hierarchy depends on the ability to use it as a store of value. Kaltenbrunner (2011) adds to this view, by arguing that a currency's liquidity premium depends on its capacity to be used to face liabilities. This depends on mainly two factors: the first is the external stock of liabilities, the second is the ability of the country issuing the currency to meet the commitments through its favourable foreign exchange position and the "institutional" liquidity of its financial markets. In such a situation, capital flows to emerging markets are doomed to be characterised by boom-bust cycles,

since investment in a country's assets will by definition occur in a phase of lower liquidity preference and higher return seeking (Biancareli, 2009; Biancareli, 2011). Once again, the policy implication of such an analysis would point towards the possibility of capital controls that may reduce the exposure of emerging countries and thus allow them to reduce the negative effects that their lower position in the hierarchy in which they are relegated by the asymmetries of the global financial system. These theories are in clear contrast with mainstream theories of financial globalisation. While both theories point to the weaker position of developing countries in the global financial system, a deeper and more liquid financial system as a result of foreign capital is a source of potential instability, as opposed to a potential way to overcome the "original sin". Unsurprisingly the new IMF stance towards capital controls is seen by many as "too moderate" and insufficient to face the problems of modern financial globalisation (Fritz and Prates, 2013; Akyüz, 2012; Gallagher and Ocampo, 2013).

#### **4. Conclusion**

This paper has attempted to give a comprehensive review of the growing literature on financialisation and other critical approaches to finance, in the context of emerging and developing economies. Differently from mainstream scholars, these authors have pointed out some critical developments arising from the rise of finance and their potentially harmful impacts on the

development prospects of those countries.

While the literature is still relatively recent and is still expanding, much can be learned from these approaches and hopefully contribute positively to the policy debates to ensure that finance best serves the needs of development rather than the other way around.

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