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THE PARADOX OF FINANCE-DRIVEN GLOBALIZATION

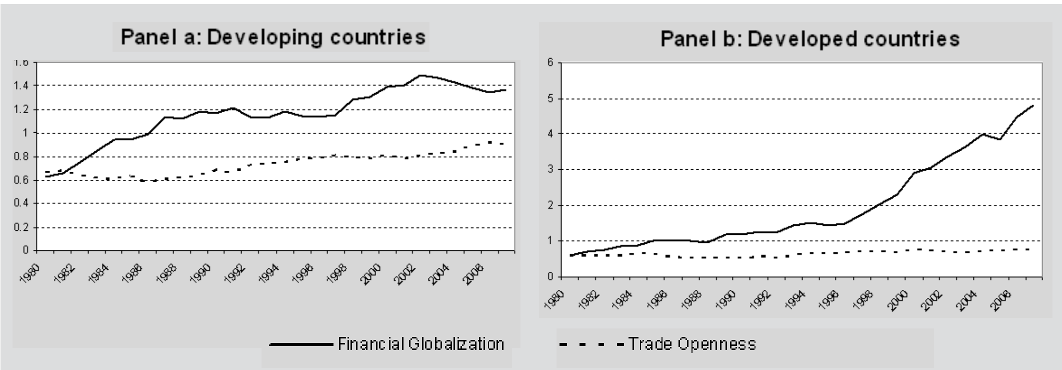
Over the past thirty years, many developing countries have experienced spurts of economic growth followed by collapses. In the process, some have fallen further behind the advanced economies, while only a few have enjoyed sustained economic growth. This policy brief explores the reasons for these diverse outcomes. It suggests that the countries with the strongest performance are those that have rejected the dominant economic wisdom of trusting their growth prospects to financial markets, and instead have pursued innovative and heterodox policies, tailored to local conditions. This has allowed them to shift resources to activities that are increasingly productive. Meanwhile, many developing countries that have embraced finance-driven globalization (FDG) have seen their ability to achieve this structural transformation greatly reduced.

The turn to financialization

Beginning in the early 1980s, the extensive deregulation of the financial sector, the dismantling of controls on cross-border financial activities and moves to open the capital account signalled a radical break with the post-war international policy framework, with capital flows surging ahead of international trade (fig. 1). Subsequently, the proportion of national income accruing to the financial sector has increased across all countries and regions, financial leverage (the ratio of debt to revenue) has risen sharply, supported by the proliferation of opaque financial products and markets, "shadow" financial institutions have emerged with heightened speculative behaviour, and corporate and even household governance has increasingly focused on quick returns from speculation on financial assets, exchange rates, real estate, and mergers and acquisitions, often fuelling asset price bubbles.

As finance has expanded its command over global resources and tightened its grip over both corporate governance and policymaking, measures of economic "success" have become disconnected from the pressures of making productive investments, raising productivity and creating jobs. In combination with a general shift to more open markets, this structural shift in the organization of economic activity and the behavioural changes in economic actors can be described as FDG.

Figure 1. Financial globalization and trade openness, 1970–2007 (finance-to-GDP and trade-to-GDP ratios)



Source: Calculations using UNCTAD database.
Note: Financial globalization is the ratio between the stock of foreign assets and liabilities and each region's GDP (left axis); trade openness is trade flow (exports plus imports) divided by the region's GDP (right axis).

Key points

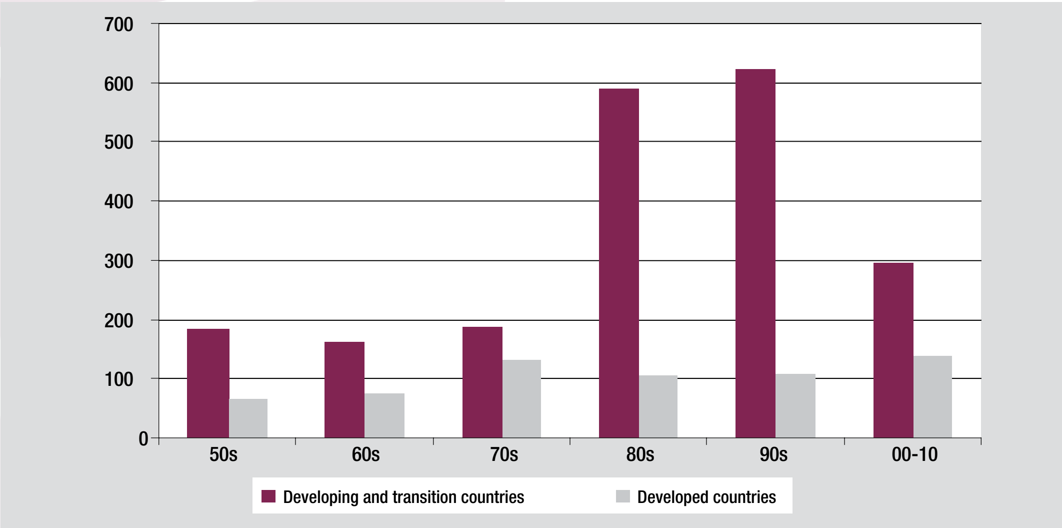
- The globalization process has been shaped by the growing financialization of economic activity
- The external environment shifted favourably for many developing countries at the start of the millennium

Conventional economic wisdom quickly embraced FDG, predicting that a combination of efficient markets and financial innovation would create a more dynamic economic environment from which all countries would benefit. In reality, FDG has coincided with a persistent slowdown in global growth, led by the advanced countries, and sluggish investment performance, despite a noticeable shift in the composition of national income towards profits in general, and financial returns in particular.

Efforts to turn things around in the new millennium through a debt-driven consumption boom did little to revive productive investment, and instead amplified a series of closely interconnected imbalances that had begun to emerge at the national and international level. Following the collapse of Lehman Brothers in 2008, the boom turned into the biggest bust since the Great Depression.

During the pre-crisis years, trade and financial conditions did improve for many developing countries, and growth picked up sharply, ending a two-decade spell of recurrent financial crises and uneven growth in the 1980s and 1990s (fig. 2).

Figure 2. Financial crises, 1950–2010

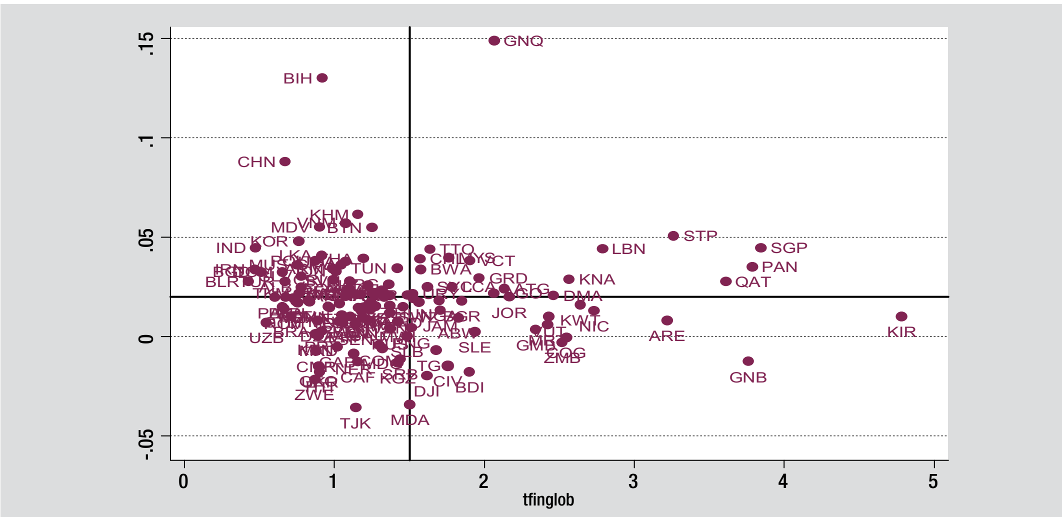


Source: UNCTAD secretariat, based on Reinhart CM and Rogoff KS. "From financial crash to debt crisis." NBER working paper 15795, March 2010.
Note: Financial crises include banking crises, currency crashes, domestic default (or restructuring), external default (or restructuring), and stock market crashes.

Country-level impact

Figure 3 plots financial globalization (tfinglob) (see fig. 1 for definition) against average real per capita GDP growth (tgry) over the period 1990–2007 for a sample of 136 developing countries. Overall, there is no evidence of a positive correlation between financial globalization and economic growth in developing countries. While there is no clear relationship between the two variables, the countries in each quadrant have certain features in common.

Figure 3. Financial globalization and output growth in developing countries



Source: UNCTAD secretariat, based on Lane PR and Milesi-Feretti GM (2006). The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970–2004. Institute for International Integration Studies. Discussion paper series no. 126.

The losers from financial globalization

The countries in the bottom two quadrants are those that have not seen a significant increase in economic growth over the period. The 52 in the bottom left quadrant have relatively low levels of financial globalization and low growth. These are typically countries facing severe constraints in terms of poverty and, in some cases, security. Meanwhile, the 24 countries in the bottom right quadrant have stuck to the logic of FDG, but this has failed to generate economic benefits. While some small island economies feature here (Kiribati and Vanuatu), many are low-income developing countries (Burundi, Guinea-Bissau and Zambia).

The winners that embraced financial globalization

The 19 countries in the top right quadrant are those where financial globalization has been associated with economic growth. They share certain characteristics: Eight are small island economies (Antigua and Barbuda, Dominica, Grenada, Seychelles, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, and São Tome and Principe), six are commodity producers (Angola, Botswana, Chile, Equatorial Guinea, Qatar, and Trinidad and Tobago), and four are regional financial centres (Lebanon, Panama, Singapore and Uruguay). Notably absent in this group are countries with a strong manufacturing sector. There is just one – Malaysia. However, on closer examination, Malaysia also tightened restrictions on flows of financial capital after 2000.

The winners that resisted financial globalization

The 41 countries in the top left quadrant are those that have managed to achieve significant gains in terms of economic growth without substantial financial globalization. These countries have followed diverse paths, but their economic gains cannot be attributed to the standard policy formula associated with FDG. Featured in this quadrant are several large emerging economies (including China and India), which have reduced significantly their income gap with the advanced countries. It also includes a number of countries – such as Viet Nam – that have successfully launched an industrialization take-off strategy.

The importance of economic structure

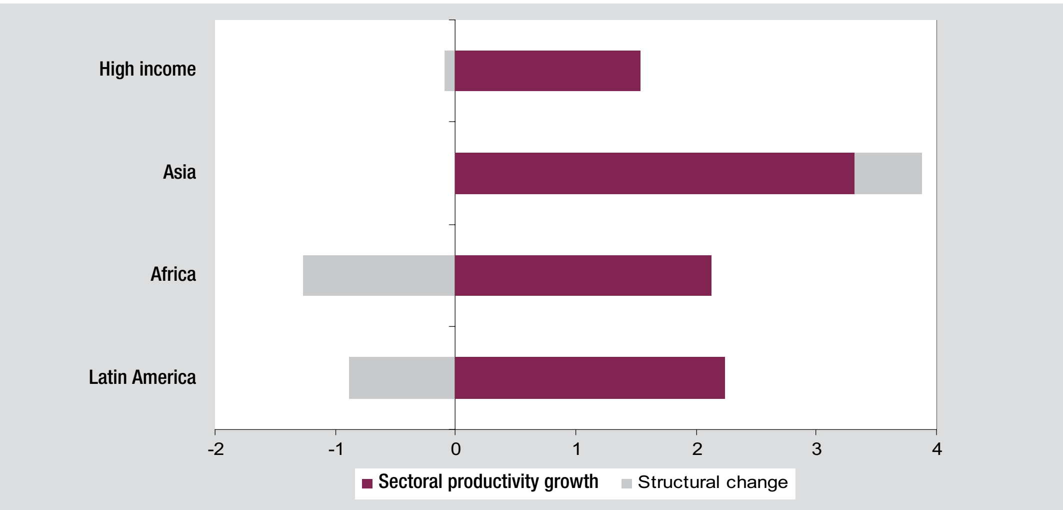
Despite the encouraging global environment facing developing countries from the turn of the millennium, FDG appears to have benefited only a small group of economies. This suggests that the developmental impact of FDG has continued to depend on structural changes at the national level.

The relationship between structural change and economic performance has been extensively analysed by UNCTAD in its annual *Trade and Development Report* and *Least Developed Countries Report*. A recent assessment by McMillan and Rodrik (2011) notes that rising productivity growth can be explained either by labour becoming more productive within a given sector, or by resources moving from low-productivity to high-productivity sectors ("structural change"). These are often mutually reinforcing. However, if the resources released from an increasingly efficient enterprise or sector are transferred to less productive activities or become unemployed, the overall impact on the economy might be negative, with the combined impact of these changes depending, in part, on the productivity differences between sectors. In high-income countries, that differential tends to be small, whereas in developing economies there is much greater variation between, for example, agriculture (where productivity is generally very low) and manufacturing (where productivity is higher).

Figure 3 shows the impact of sectoral productivity growth (the black bar) and structural

- **Finance-driven globalization has produced winners and losers in the developing world**
- **The key to long-term success continues to depend on establishing strong links between resource mobilization and structural transformation**
- **Effective policies matter to establishing the right linkages**

Figure 4. Decomposition of productivity growth by country group, 1990–2005



Source: McMillan and Rodrik (2011).

change (the grey bar) for Asia, Latin America and Africa as well as high-income countries between 1990 and 2005. Not surprisingly, the impact of structural change is small in high-income economies, as the differential between sectors is small. Turning to the other regions, all have gained from productivity growth within sectors (the black bar), but where Asia differs from Latin America and Africa is that the impact of its structural change has been positive, whereas for both Africa and Latin America it has been negative.

The success of Asia, therefore, is not so much in improving productivity within sectors – similar across all regions – but in achieving structural transformation from low- to high-productivity sectors.

FDG and structural transformation: a missing link

It seems that many developing countries that have enjoyed economic gains without embracing financial globalization (the upper left quadrant of fig. 3) have been successful in creating positive structural change (as in fig. 4) through the effective mobilizing and channelling of productive resources. By contrast, a missing link for countries embracing FDG involves the difficulties they have had in mobilizing sufficient resources to build productive capacities.

In most developing countries, investment rates tumbled in the 1980s, and they have failed to return to their previous levels. The retrenchment of public-sector investment has been especially pronounced, and in most cases, private (domestic and foreign) investment has failed to fill the gap. This failure is partly due to the fact that FDG has had an adverse impact on household savings, through three different channels: (a) wage incomes have been squeezed; (b) banks have moved away from the business of long-term investment projects, to become heavily involved in lending to consumers and governments; and (c) trade and financial liberalization have raised the propensity to consume, including luxury goods, and have fuelled speculative purchases of real estate. Moreover, while profit levels have often risen, financialization has also had a damaging impact on the profit–investment nexus, by channelling retained profits into less productive activities.

Without going into detailed country profiles, success stories have been able to adopt creative and heterodox policy innovations tailored to local conditions. Many have established a strong investment–export nexus by managing their outward orientation with strategic policies including high (but temporary) tariff and non-tariff barriers, publicly owned development banks, directed credit, domestic-content requirements, and capital controls. In addition, some have used targeted industrial policies to diversify their economies, developing a wider range of more productive activities. Such diversification appears to be closely linked to improving employment conditions and to build resilience against adverse shocks.

These successful countries have often built up productive capacity in the context of strong regional growth dynamics. They have managed to raise the pace of capital formation and have achieved successful structural transformation into higher-productivity sectors, with dynamic linkages to the rest of the economy. Taking the cases of India and Thailand, both of which are in the top left quadrant of figure 3, McMillan and Rodrik (2011) demonstrate, in both cases, a significant reduction in the employment share accounted for by agriculture and an increase in the share allocated to higher-productivity sectors such as manufacturing. The lower scores on financial globalization for these countries are associated with positive structural change.

In contrast, as discussed extensively in UNCTAD publications, the countries that have embraced FDG and rapidly liberalized trade and finance have often had to deal with volatile capital movements, rapid shifts in exchange rates, and speculative boom–bust cycles. Financial and balance of payments crises of increasing severity have become a regular feature of the economic landscape, culminating in the deepest economic collapse since the Great Depression. Moreover, the close interaction between financial and trade liberalization has often inhibited government policies promoting industrial capacity.

In sum, productivity-enhancing structural change does not emerge spontaneously from unleashing (financial) market forces, but rather is the result of concerted government policies to raise capital formation, strengthen productive capacities and diversify the economy. A narrow preoccupation with improving the efficiency of specific industries or sectors by exposing them to international competition, mediated by unregulated financial flows, can have a strongly adverse impact on the performance of the economy as a whole.

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Reference

McMillan M and Rodrik D (2011), Globalization, structural change and productivity growth. Working paper 17143. http://www.nber.org/papers/w17143; UNCTAD (2003 and 2006), *Trade and Development Report;* UNCTAD (2007 and 2009), *Least Developed Countries Report.*

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