Developing Economies, International Financial Integration, and Sustainable Development

Gary Dymski, University of Leeds[1]

25 November 2018

1. Introduction and context

This paper constitutes one contribution to the second Intergovernmental Group of Experts (IGE) session, convened by the United Nations Conference on Trade and Development as a result of the Addis Ababa Action Agenda agreed at the third international conference on financing for development in 2015. A key finding point of the first IGE session in 2017, and of research conducted by the UNCTAD Debt and Development Division, was that debt and financial stress have grown markedly amongst emerging economies since 2009, due to a large extent to debt flows from overseas lenders. This finding raised a series of questions, to be addressed in a second IGE session. These questions included: (1) how might current debt vulnerabilities in developing countries be mitigated, and developing country sovereign debt and financial crises prevented; (2) how sovereign debt financing, both external and domestic, could be leveraged for sustainable development; (3) what institutional changes are required at the global systemic level to achieve sustainable development and debt management; and (4) how to better resolve sovereign debt problems.

Presentations at the 2nd IGE session responded to these questions. This paper addresses the third question – the systemic global links between developing countries and international finance. It is essential here to undertake an historically informed analysis, so as to understand advanced economies' financial power, developing economies' financial stress, and the problematic of financing sustainable development. After section 2 briefly describes the collapse of the formerly regulated systems of finance (focusing here on the US case), our analysis unfolds below in three steps. The first step (section 3) is to recognize the forces shaping the global architecture of finance from the 1980s through the present: the emergence and evolution of the financial globalization dynamic, the international financial integration to which it has led, and – critically – the means by which this globalized system avoided a meltdown in 2008. The second step (section 4) then is to understand the position of developing economies within this evolving global system. The third step (section 5) involves understanding to what extent developing economies can make purposeful use of finance to support sustainable development.[2] Section 6 briefly concludes.

2. US finance, 1970s to present: deregulation and banking transformation

Financial institutions and practices underwent rapid change in the 1980s after a deteriorating macro environment in the 1970s put the heavily-regulated banking systems of advanced nations in jeopardy.

---

[1] Address: Leeds University Business School, University of Leeds, Leeds LS2 9JT, UK. Email: g.dymski@leeds.ac.uk. This paper is based on a short verbal presentation to the Intergovernmental Group of Experts on Financing For Development Second session 7–9 November 2018, Palais des Nations, Geneva. The author thanks Jane D'Arista, Stephanie Blankenburg, Beulah Chelva, Annina Kaltenbrunner for insightful discussions that clarified some of the arguments made here. Beulah provided key support in data gathering and analysis. Any errors that remain are the sole responsibility of the author.

[2] Note that the remainder of this paper expands on the key points made in a succinct oral statement presented to the assembled delegates of the 3rd IGE session of UNCTAD on November 7, 2018. That presentation summarized the logic of the global system of finance, as well as its implications both for developing countries and for the capacity of these nations to participate in the attainment of the United Nations' agreed sustainable development goals. This paper covers this subject in more depth, with the use of several figures that were excluded from the presentation as delivered.

High rates of price inflation in the 1970s led to high interest rates, which led to balance-sheet stress in the heavily-regulated commercial banking and thrift systems of the United States. Banks were losing traditional blue-chip loan customers and high-balance depositors to direct credit markets and mutual funds. Large banks expanded their lending abroad to replace lost domestic customers.

Deregulation began in earnest with the passage of the Deposit Institutions Deregulation and Monetary Control Act of 1980 in the United States, the initiation of an extended period of bank consolidation in the 1980s and 1990s, and a shift toward market-based finance. The basis of mortgage finance shifted from dedicated local circuits of capital, based on pooled savings, to securities purchased and underwritten by quasi-public agencies sold into the broader markets, including to foreign wealth-holders.

During the 1980s and 1990s, financial markets grew grown continually in scale and scope. Private underwriters stepped into credit markets and more buyers of non-bank credit emerged, expanding the range of contracts that could be securitized. The expanding set of spot and contingent contracts facilitated both cross-border lending and the transfer and hedging of credit and exchange risks. Consequently, bank-based, originate-to-hold lending was gradually replaced by market-based, originate-to-distribute lending; securitization and the 'shadow banking' industry supporting it grew steadily, its liquidity enhanced by an expanding complex of clearinghouses, exchanges, and broker-dealer firms.

3. The emergence of a global financial dynamic

Since the 1980s, international financial markets' evolution has unfolded according to a global dynamic defined by two elements: first, a restructuring of global banking, originating in the US and spreading through most advanced economies; second, the asymmetric current- and capital-account position of the US from the 1980s onward. These two elements emerged in the context of another trend not investigated here – an increase in multinational firms' offshore production facilities in lower-cost regions.

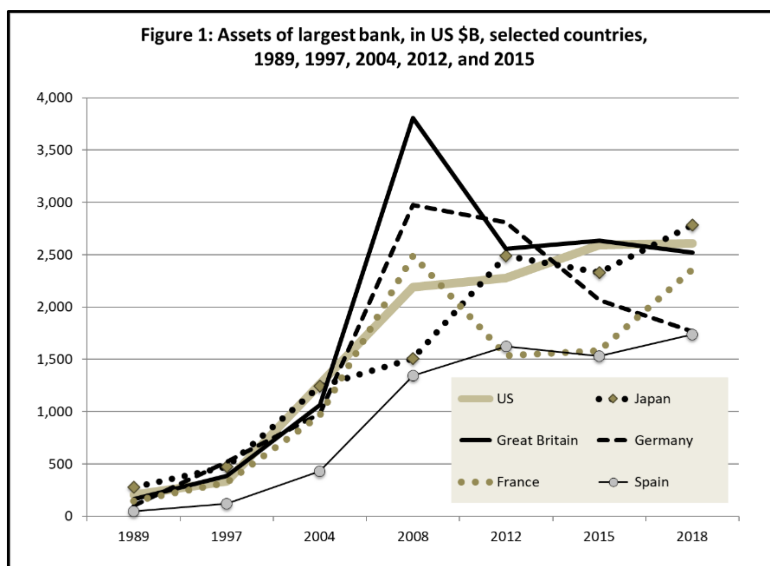
In the United States, money-center banks were at particular risk as regulated banking disintegrated in the late 1970s: they lost depositors to money-market mutual funds and 'blue chip' customers to direct credit markets. To compensate, they turned to borrowed funds and to borrowers in less developed countries, especially in Latin America.[3] Similar pressures led to banking deregulation in other advanced nations, and to these nations' expansion into overseas lending in this period. When high and volatile interest rates and a decline in commodity prices led to systematic defaults by Latin American borrowers, a serious debt crisis arose. Given the balance-sheet fragility of US money-center banks, the US Comptroller of the Currency declared these banks 'too big to fail.' Again, while not so explicitly declared, other nations also took steps – then or later – to protect their largest banks.

In the 1990s, these same factors – in particular, the exhaustion of traditional loan markets and competition for size and market share among large and increasingly deregulated banks, in the US and in Europe in particular, led to repetitions of overseas lending excesses – notably East Asia. Recurrent financial crises became a defining feature of the post-1980 global economy.[4] The opening of new lending markets for globally-active banks, along with post-crisis adjustment programs typically

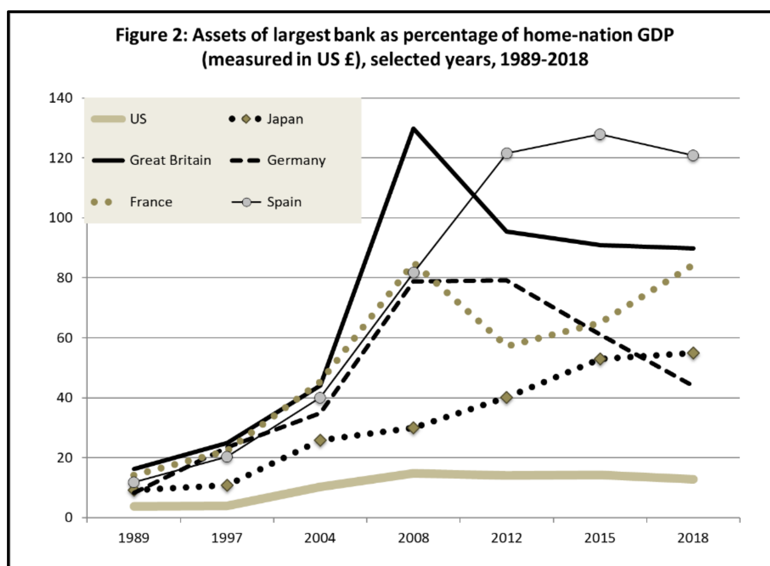
[3] It is important to recognize that lending to Latin American borrowers was only one cause of the extended crisis of advanced-economies' banking systems in the 1980s. See, for example, the *History of the Eighties: Lessons for the* Future, Federal Deposit Insurance Corporation (FDIC), Washington DC, 1997.

[4] Luc Laeven and Fabián Valencia, "Systemic Banking Crises Database: An Update," IMF Working Paper WP/12/163, Washington DC: International Monetary Fund, June 2012.

orchestrated by the International Monetary Fund (IMF), led to increased entry by foreign banks into developing-economy markets. Frequent crises and post-crisis adjustment programs, in turn, led to an erosion in (if not the disappearance of) development banking capacity in many countries. State planning and developmental institutions were also dismantled.



Against the backdrop of increasingly frequent financial crises, especially in emerging economies, constraints on financial flows were continually removed in these years. The Delors Commission report of 1989, which led to the European Union's single market, called for "the full liberalization of capital movements and financial market integration." European governments' preparations for the single market included the use of bank mergers to create national banking champions. In turn, the US repealed its Depression-era Glass-Steagall Act in 1999, opening the way to fully deregulated activities by financial conglomerates.

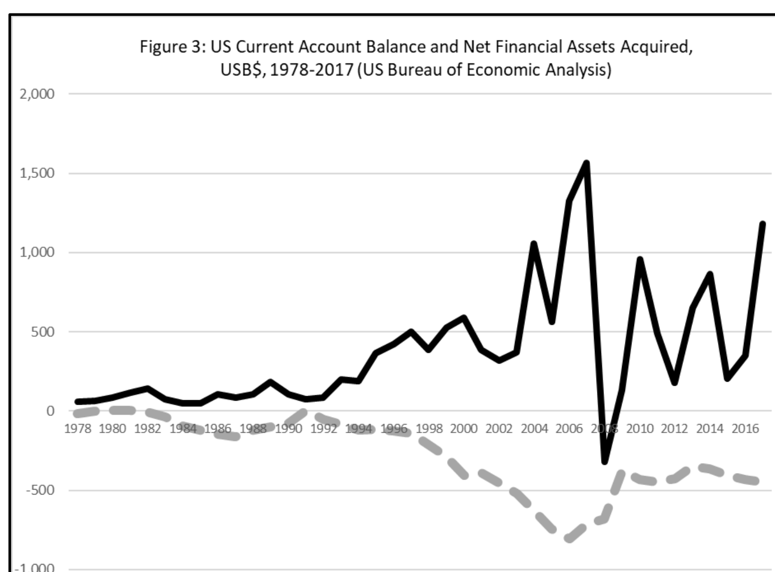


These changes in legal constraints, together with the rapid spread securitization, facilitated the growth of the large banks that, together with growing networks of non-bank banks, dominated the 'originate-to-distribute' markets. Consequently, the explosive growth of securitization was paralleled by that of non-bank lenders, debt, and the large global banks that dominated these markets. The largest banks in advanced economies grew at accelerated rates from the late 1980s into the 2000s, as

Figure 1 demonstrates. Figure 2 makes the further point that the asset size of these nations' largest banks came to exceed that of their home-nations' GDP in the years leading up to the global crisis (several years between 1989 to 2008 are shown in these figures).

Initially, the growing numbers of non-banks providing customers for bundled, securitized credit, together with the surge in the supply of credit provided for home purchase and refinancing, for commercial real-estate development, and other purposes, led to great confidence that financial-market efficiency had reached a new plateau. Worries were expressed about the opacity that characterized the instruments being brokered by the 'passive financial intermediaries' at the heart of this new financial system.[5] But the willingness of credit-rating agencies to certify a large volume of securities as investment-grade, and the reliance of the revised Basel Accords on large banks' own assessment of their risk exposure, led to these worries being set aside.

By 2007, a downturn in US housing prices, the increasingly precarious financing positions of borrowers, and the interconnections among the global systematically-important banks all combined to trigger an implosion of global financial assets and equity prices, launching what Tooze has termed a 'decade of financial crises.'[6] As Tooze has pointed out, the extent and depth of this crisis – which ranged across the US and Europe, and profoundly affected every region of the world – starkly demonstrated the deep integration of the global financial system. Thanks to the measures taken by governments, central banks, and international agencies around the world, this system largely survived intact, and global depression was averted.



The second factor facilitating this global financial dynamic was the emergence of a systematic US current-account deficit and capital account surplus. This situation can be traced in part to a shift of

[5] The term in quotations appears in Oldfield, George S. "Making Markets for Structured Mortgage Derivatives," *Journal of Financial Economics* 57 (2000) 445-471. To see the doubts about how to characterize the risk and other characteristics of securitized debt that emerged even as this new system of market-based lending was gathering momentum, compare the working paper and published versions of this paper by Fender and Mitchell: Ingo Fender and Janet Mitchell, "Risk, Complexity, and the Use of Ratings in Structured Finance," working paper, Bank for International Settlements and National Bank of Belgium, March 2005; and Fender and Mitchell, "Structured Finance: Complexity, Risk and the Use of Ratings," *BIS Quarterly Review*, June 2005, 67-87.

[6] Adam Tooze, *Crashed: How a Decade of Financial Crises Changed the World*. London: Allen Lane, 2018.

US companies toward outsourced and global factory-based production, as well as to the emergence of competitive producers elsewhere in the world. Macroeconomic accounting can readily be used to show that these two imbalances are systematically connected for any economy. Figure 3 illustrates the persistent US current account deficit, and net capital inflows from the early 1980s to the present.

This persistent structural imbalance has global consequences. An immediate consequence is that there has been, through these years, a steady inflow of money into the US looking for assets to buy. A further consequence is that the US has been systematically exporting the ownership of its liabilities – T-bills and T-bonds are held in reserve portfolios the world over. These in turn, once obtained, become 'safe assets' that provide both security against speculative financial attacks and also high-quality collateral in the event of the need for further borrowing. The tremendous growth of global reserves reflects both the importance of protections against speculative attacks and also the growth in the size and intensity of these attacks – the possibility of 'sudden stops.'

The interplay of these two structural factors since the 1980s has been underscored by the asymmetric treatment of the ultimate lenders and borrowers in the episodes of deep financial distress on both ends of this historical epoch – the early-1980s' Latin American financial crisis and the late-2000s' subprime meltdown. While large US banks (and other adanced-nations' lenders) survived the Latin American default of 1982 relatively unscathed, borrower nations experienced a 'lost decade' with diminished economic growth; their debts were not forgiven, but were consolidated into Brady bonds on which payments were made into the 2000s.[7] This asymmetry of outcomes – in which debts taken on initially by private parties are converted into the sovereign-debt obligations of developing nations, while lenders' losses are mitigated – foreshadowed the treatment of bad debt in the subprime crisis.[8]

3. International financial integration

Developing countries' vulnerabilities are not due to their failure to organize themselves and to create policy space for themselves; they are bound within the constraints imposed by a world whose policy parameters are shaped by unregulated international financial markets. And while too-big-to-fail megabanks are protected by national governments, they are unaccountable and part of a financial megaplex that protects its flexibility.

The result has been global financialization and a 'business of debt' that permeates the activities of households and firms. Throughout the world, falling wages for workers, and the loss of development-banking capacity to support enterprise, has made increased debt a necessity for a larger and larger share of economic units. Complementing this 'demand' is the rise of market-based lending. This has created a set of instruments that can be sold to customers who are risky, for reasons

[7] The Brady bond process continued into the 1990s and was used to restructure the debt of nations outside Latin America; by 1999, $130 billion of Brady bond debt was outstanding. Mexico retired its last Brady bond in 2003, Brazil in 2005.

[8] In the US, the Emergency Economic Stabilization Act of 2008 authorized the Troubled Asset Relief Program to provide support for affected banks and for homeowners with 'underwater' mortgages. Just over half of the $205 billion authorized for capital support for banks, $115 billion, was paid out to 8 large banks in October 2008. Some $50 billion was set aside for homeowner relief; as of 2016, only $27 billion had been paid out. According to the US Treasury Department, approximately 1.5 million homeowners received some form of mortgage modification under federal and state programs. An estimated 12 million homes were foreclosed due to the subprime crisis; one in every 12 US homeowners having initiated foreclosure proceedings after 2007, with minority homeowners and neighborhoods being disproportionately impacted (Matthew Hall, Kyle Crowder, and Amy Sprint, 'Neighborhood Foreclosures, Racial/Ethnic Transitions, and Residential Segregation,' *American Sociological Review* 80(3), 2015: 526-49.

unrelated to ‘productive use’, backstopped by national governments that have largely immunized the investor/lender sector against loss.

As noted in Section 1 above, the integrated system of global finance that matured in the early 2000s generated an unpayable excess of debt by 2007, leading to a global financial crisis in 2008. IMF staff attempted both to construct a database of the last four decade’s financial crises and to assess their cost. For example, Laeven and Valencia (2010) estimated banking crises in the 1970-2006 period had cost output losses of 33 percent of GDP; and the 2007-2009 crisis had cost a further 25 percent; these authors calculated that emerging markets had lost 29 percent of GDP to 1970-2006 crises, and only 5 percent to the 2007-09 crisis.[9] A significant 2015 IMF study found that the countries most exposed to risk of loss from future financial crises are those with large banking-asset/GDP ratios and/or with high debt levels.[10]

In the post-crisis period, some of the megabanks at the heart of global finance have shrunk, either in absolute terms or relative to GDP, but others have continued to grow, or have resumed their growth; The depictions of the largest banks’ sizes in six advanced economies, shown in Figures 1 and 2 for the post-crisis years of 2012, 2015, and 2018 provide an illustration of this mixed post-crisis experience. Even where shrinkage has occurred, these large banks’ excessive size relative to their home economies implies that they must grow faster than those economies, *ceteris paribus*, to avoid declining rates of return.

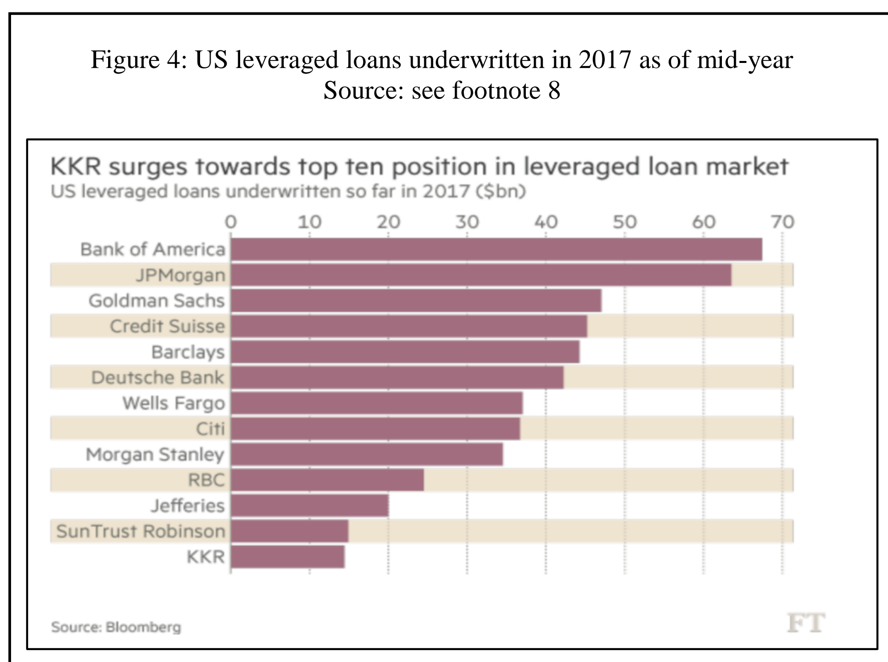


Figure 4: US leveraged loans underwritten in 2017 as of mid-year
Source: see footnote 8

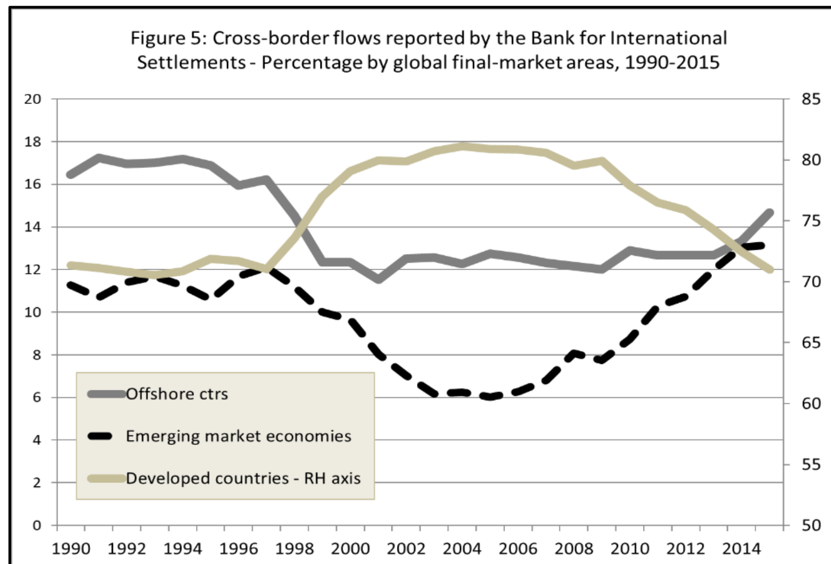
As in the 1980s and 1990s, this means developing new instruments in their home markets, and by looking again to grow their position in emerging market economies. On the home-economy front, in both the US and Europe, the latest area of innovative and possibly risky growth is the largely

---

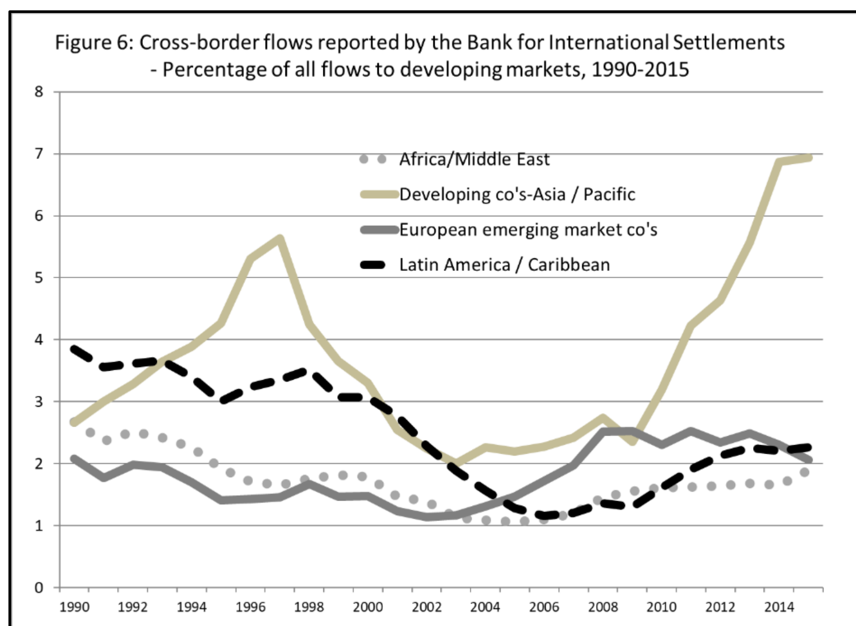
[9] Luc Laeven and Fabian Valencia, ‘Resolution of Banking Crises: The Good, the Bad, and the Ugly,’ *IMF Working Paper* WP/10/44. Washington, DC: International Monetary Fund, August 2010. Tooze (2018), referenced in footnote 6, notes that emerging economies, as well as European Monetary Union countries, felt the brunt of the crisis that began in 2007 only after 2009.

[10] David Amaglobeli, Nicolas End, Mariusz Jarmuzek, and Geremia Palomba, ‘From Systemic Banking Crises to Fiscal Costs: Risk Factors,’ *IMF Working Paper WP/15/166.* Prepared by

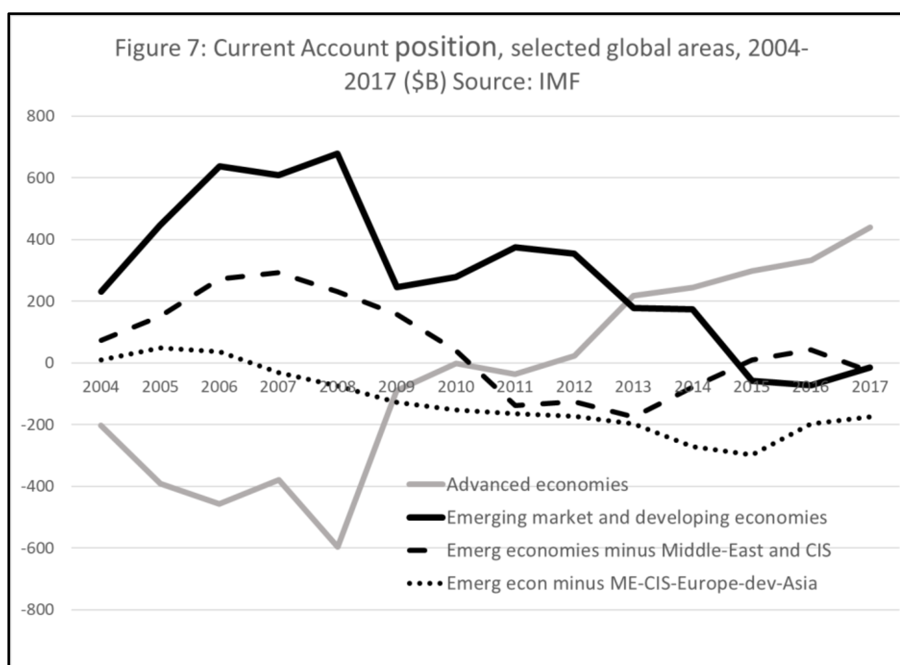
unregulated $2 trillion leveraged loan market. Figure 4 illustrates that many of the same banks that were active in subprime lending and securitization are dominant in US leveraged lending as well.[11] Other areas of domestic megabank expansion include the resumption of subprime lending, the entry of at least one megabank into the payday lending market, and the rapid expansion of the automobile and student debt markets.



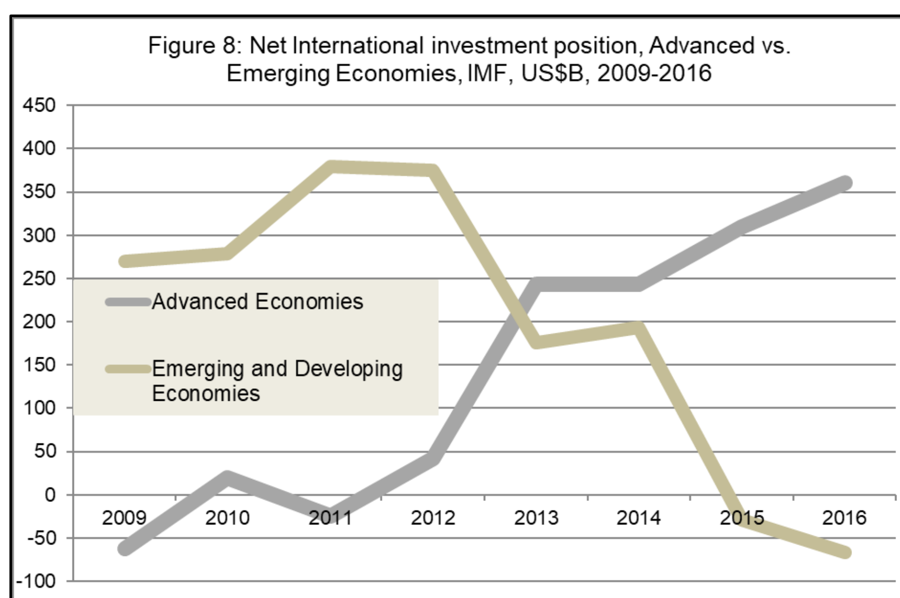
Lending to borrowers in emerging-market economies has also gathered force in the post-crisis period. Figure 5 shows that cross-border lending flows as reported by the Bank for International Settlements (BIS) have shifted away from advanced economies and toward emerging markets. Figure 6 provides some detail on lending to different sub-areas within the emerging-market cluster; it shows that emerging Asia has accounted for virtually all of this percentage increase, with cross-border flows to Africa, Latin America and the Caribbean, and emerging Europe closely bunched.



[11] See Eric Platt, 'KKR muscles into US leveraged loan business,' *Financial Times* 20 June 2017. Figure 4 appears in this source.



This shift of this global lending flows toward emerging markets should be seen in light of broader cross-border macroeconomic imbalances, as discussed above. And Figures 7 and 8 demonstrate that the aggregate structural position of advanced and emerging-market economies has indeed been shifting in the post-crisis period. Figure 7 shows that whereas emerging-market economies, taken as a whole, held a surplus current account position prior to the crisis, offset by advanced economies' deficit position, that relationship has steadily been reversed in the post-crisis period. The developed economies – many vigorously pursuing austerity policies, as Tooze (2018) has demonstrated – now are in surplus, while emerging markets are in an aggregate deficit position. Figure 7 successively removes Middle-East and the CIS countries, and then emerging Asia; but the pattern persists even when Latin America and Africa constitute the bulk of the emerging-market group.



This pattern is reinforced by BIS data on net international investment position, as shown in Figure 8: between 2009 and 2016, the advanced economies have shifted from a net debtor to a net creditor position, while the opposite has occurred for developing economies.

The global patterns shown in Figure 7 and 8 demonstrate that developing countries' vulnerabilities cannot be attributed solely to their governments' failure to be sufficiently disciplined: these countries are operating within the structural parameters of a world system in which much larger nations (in terms of GDP size) have been systematically pursuing austerity policies whilst providing a backstop for the megabanking sectors whose very size mandated the implementation of (declared or undeclared) too-big-to-fail policies. That these megabanks and the shadow-banking system that surrounds them were chastened and made to reinforce their capital buffers post-crisis does not change the fact that the extraction of rentier income by hyperglobalized, inadequately regulated megabanks and megafirms in international financial markets is worsening global inequality and squeezing developing-economies' policy space still further.[12]

4. Asymmetric lender-of-last-resort capacity, unsustainable national provisioning and sustainable development

The asymmetric resolution of the decade of global financial crises has, then, increased global inequality and exposed the weak financial substructures on which the celebrated takeoff to post-2000 growth of various combinations of developing nations – first the 'BRICS', and then the 'MINT' countries – was based. Expectations that financial deepening would accelerate growth have been replaced by warnings of 'too much finance.'[13]

It is in this context that post-crisis concern about increasing corporate debt and debt servicing burdens, especially in developing countries, has arisen. Heightening this concern is the fact that these commitments are in many cases bundled into opaque instruments subject to legal frameworks largely controlled by financial centres, and exposed to volatile investor sentiments. The asymmetric power of global financial markets relative to national governments has led Rey (2013) to famously argue that monetary-policy independence has been largely eradicated, in a world driven by global financial cycles.[14] Developing economies provide bubble- and fad-driven venues that either accompany booms or provide investment outlets in busts.

Only one nation within this system has the capacity to be a global lender of last resort. It is precisely because of that capacity – linked to the 'exorbitant privilege' of the US – the government of the US has little incentive to rein in the arsenals of financial speculation. The US's central bank was able to rescue the increasingly risky system a decade ago. A second test of that capacity may not be feasible, for reasons explained by Tooze (2018) and made clear in an extended Brookings Institution interview with Ben Bernanke, Tim Geithner, and Henry Paulson: working through the pressurized choices during the global meltdown required close cooperation among private-sector and governmental principals, necessitated bending the letter of the law, and depended on close cooperation with the executive leaderships of the US, UK and Europe.[15] Working relationships and

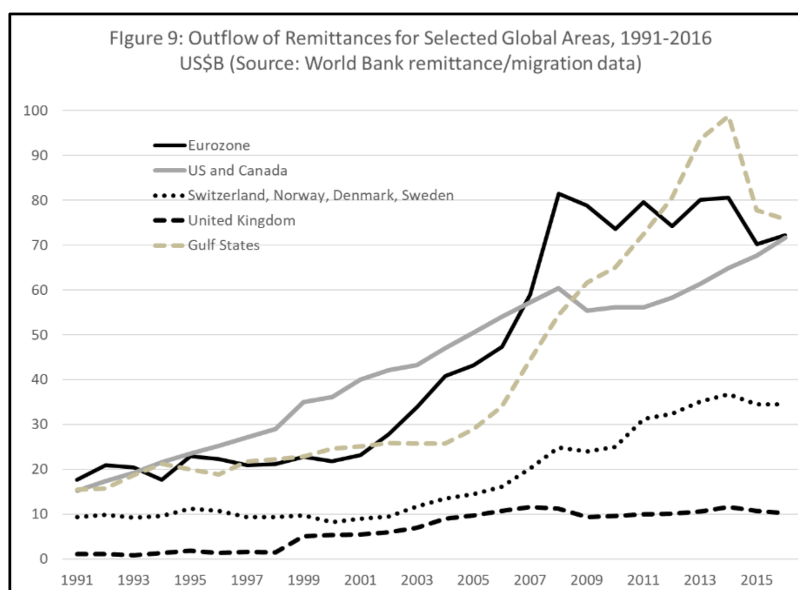
---

[12] See chapter 6 in the 2017 *Trade and Development Report*. Geneva: United Nations Conference on Trade and Development, 2017.
[13] Jean-Louis Arcand, Enrico Berkes and Ugo Panizza, 'Too Much Finance?' *IMF Working Paper WP/12/161*. Washington, DC: International Monetary Fund, June 2012.
[14] Hélène Rey, 'Dilemma not trilemma: The global financial cycle and monetary policy independence,' *Proceedings - Economic Policy Symposium - Jackson Hole.* Kansas City: Federal Reserve Bank of Kansas City, 2013. Pp. 285-334. Thomas Palley offers an alternative, complementary, explanation; see his 'A theory of Minsky super-cycles and financial crises,' *Contributions to Political Economy* 30(1), June 2011: 31-46.

[15] 'Ten years after the financial crisis: Reflections by Bernanke, Geithner and Paulson,' video transcript edited by Jeffrey Cheng and David Wessel, recorded September 19, 2018 at the Brookings Institution, Washington, DC. See https://www.brookings.edu/blog/up-front/2018/09/19/reflections-by-bernanke-geithner-and-paulson/

trust among policy principals in the advanced nations have eroded in recent years, as has the policy space for the sort of unilateral actions needed to quell fast-developing crises.

The apparent resolution of the global financial crisis, celebrated at the aforesaid colloquoy, was followed since 2009 in the advanced economies by austerity policy; after a lag, austerity policy was adopted almost universally in the developing nations, China being the outstanding exception. The resulting pattern of global austerity, urged by financial-market analysts and finance theorists as a way to increase the global stock of 'safe assets', has steadily compromised the capacity of sovereign nations to provide for the welfare of their citizens. Austerity, which represents the consequence of not confronting the global financial crisis, affects developing countries as much as advanced nations.



The long chain of events, then, from the spread of global finance, to recurrent financial crises, to their subordinate position in the global response to the global financial markets' extended meltdown in the past ten years, has drained many developing nations of the capacity to provision for their citizens.[16] The global increase of economic migration, and the concomitant rise in remittance payments, is a consequence of the breakdown of provisioning mechanisms in many developing nations. Remittances are now larger than all global cross-border flows apart from foreign direct investment; and much of their growth (and that of economic migration) has been occurring in nations in which social-democratic governments are under assault. Figure 9 sets out World Bank data for the regions with the highest levels of remittance outflows.

These structural dilemmas are coming to a head just when the need for global action to address global problems has become crystal clear. Recent years' setting of targets for sustainable development and for a response to climate change represent unprecedented levels of global cooperation. But achieving the sustainable development goals, and responding to climate change will require in all likelihood investment flows and fiscal transfers from developed to developing nations. We need, for this purpose, financial instruments that are purpose-driven, and which are not exposed to financial speculation.

[16] Of course, a series of non-financial factors could be sited here as well. The point made is simply that global financial structures, as these have evolved, experienced crises, and then been reconstructed in advanced economies, have crucial implications not just for developing economies' policy space but for the well-being of their citizens.

5. Conclusion

This paper represents a response to the question, 'what institutional changes are required at the global systemic level to achieve sustainable development and debt management?' We have argued that one key change is to address the oft-cited 'out of control' behaviour of hyperglobalized financial markets; however, we have also attempted to establish that this behavior has global structural roots. The increasing freedom of action of finance since the 1970s has been accompanied by unremedied global cross-border imbalances. Acknowledging this link shifts analytical attention from national deficits and debt burdens to imbalances in global capital and current-account flows. These global macroeconomic imbalances underly the global financial flows that are orchestrated, however unstably, by advanced nations' financial centres. So achieving 'sustainable development and debt management' requires both a renewal of macroeconomic growth globally and a shift in the purposes and uses of finance.

IMF programs deployed to address structural deficits for individual nations fail to deal with the systemic logic of this global situation – nations with financial stress face adverse macroeconomic environments and financial punishments rooted in global dynamics. Restoring the policy space for nations to work cooperatively with market forces, instead of being cowed by them, will require a willingness to acknowledge that a sovereign nation cannot be treated as 'just another borrower' by a financial institution operating under the legal protections offered by advanced nations' legal systems. Doing so invisibilizes the reality that nation-states are hubs for human communities. Resolving debt crises by protecting the privileged and ignoring the marginalized – as happened in the wake of the subprime crisis in the US and Europe – damages the 'commons' that bind nations and regions together. As Odette Lienau (2016) has recently argued, the question of 'legitimacy' in sovereign debt restructuring has to be addressed, with all of its 'political complexity and distributional ramifications.'[17]

We must emphasize again the centrality of the macroeconomic/financial linkages in global economic dynamics. Resolving debt problems as a means of restoring the state-market balance will require not just the reversal of macroeconomic stagnation worldwide, but also debt restructuring. Enabling nation-states to participate fully in addressing climate-change action and human-development deficits with the urgency required will require multilateral debt renegotiation. It is hoped that our discussions in Geneva, undertaken in a spirit of global cooperation and mutual understanding, will represent a small step toward a fairer global economy.

[17] Odette Lienau, 'The Challenge of Legitimacy in Sovereign Debt Restructuring,' *Harvard International Law Review* 57(1), 2016: 151-265. The brief quotation is from page 151 of this article.