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Chapter II

FINANCIALIZATION AND ITS MACROECONOMIC DISCONTENTS

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A. Introduction

The growing influence of financial markets and institutions, known as "financialization", affects how wealth is produced and distributed (UNCTAD, 2011). Consequently, the increasing integration of developing and transition economies (DTEs) into the global financial system, and the acceleration of capital flows into these countries since the turn of the millennium, have fuelled discussion about the links between openness, financial deepening and economic development. Increasing financial integration has the potential to enhance access to external financing for development. However, this chapter argues that there has been only a weak link between the integration of most DTEs into global financial markets and their long-term development. This link has experienced further strains in recent years due to overabundant liquidity generated by central banks in developed countries. While several DTEs have exhibited strong growth and current account surpluses (or lower deficits) over the past decade, accumulating, in aggregate, considerable external reserve assets, their greater openness to increasingly large and volatile international capital flows, especially short-term speculative flows, has exposed them to the risks of financial boom-and-bust cycles.[1] This chapter details the implications of such risks from a macroeconomic perspective.

Financial flows to DTEs in the period since the 2008–2009 crisis reflect a previously established pattern of macroeconomic drivers that started to emerge in many countries beginning in the 1980s: a long-term deterioration in the global wage share and reduced public sector spending in the developed economies, which have contributed to the dampening of global demand. Global growth has been based mainly on expanding financial liquidity and the generation of credit and asset booms. After the crisis, developed-country policies of quantitative easing, coupled, after a brief expansionary interlude, with fiscal austerity, have largely perpetuated this pattern.[2] The promise of higher returns on investments in DTEs, and perceptions that they posed lower risks than before, made them an attractive alternative for international investors. However, an increasing proportion of the resulting financial flows into these countries has tended to be short-term or of a more speculative nature, and they are already exhibiting the type of volatility reminiscent of conditions that preceded financial crises in a number of DTEs in the 1980s and 1990s.

This chapter first considers financialization in DTEs at an aggregate level, and highlights the relationship between capital flows and factor income payments, and the resulting pressures on trade balances. The higher aggregate rates of return on DTEs' liabilities relative to those earned on DTEs' assets are an insufficiently acknowledged and potentially

problematic aspect of these relationships. Existing patterns point to unsustainable trends for the current account, therefore leading to greater financial fragility. Moreover, in the current context of sluggish recovery from the crisis, which requires strong contributions to global demand, especially by surplus countries, the pressure to mitigate the effect of net factor income losses on the current account is counterproductive for global welfare.

This chapter then discusses the implications of financialization for domestic macroeconomic policy. It argues that excessive financial flows alter prices and influence policy in ways that compromise the potential for sustainable growth and development. With fully open capital accounts, monetary authorities become more exposed to the pressures and expectations of external finance. In particular, large capital inflows generate pressures for exchange-rate appreciation, which is exacerbated by a widespread commitment to maintaining extremely low rates of inflation as a goal in itself. The reach of fiscal policy is similarly limited by a compulsion to maintain a finance-friendly public policy stance, which discourages policy intervention on both the expenditure and revenue sides. The result is a tendency towards a deflationary macroeconomic environment, coupled with structural fragilities in the systems of finance and productive investment. All of this discourages both the growth of robust aggregate demand and the deepening of productive capacity.

The expected repercussions of these fragilities on domestic aggregate demand are then discussed by reviewing the history of several financial crises in terms that link surges in speculative finance with private sector risk-taking and subsequent public sector losses. Those losses are incurred as governments eventually and universally assume the risks and costs generated by private speculation and production failures. A broader, stylized framework then juxtaposes domestic and external sources of economic growth, emphasizing how past conditions parallel those that prevail today.

The chapter concludes with a discussion of a number of policy responses that developing countries could consider in the light of these fragilities. Such responses would aim at better managing financialization and its macroeconomic effects, as well as strengthening the link between fiscal and monetary policies and development goals. Strong domestic financial regulation needs to be at the core of efforts to harness the benefits of international finance. Instead of relying on narrowly conceived inflation targets and high interest rates to manage capital inflows and the balance of payments, a judicious combination of capital controls and exchange rate management, including by influencing the amount and composition of capital inflows, would help maintain access to productive external finance while also encouraging domestic investment. Proactive fiscal and industrial policies are also essential for generating the structures and circumstances that support domestic productivity growth and the expansion of aggregate demand. Given the extent of financialization and the large size of global capital flows, however, macroeconomic management at the national level must be supplemented by global measures that discourage the proliferation of speculative financial flows. Further support can be provided at the regional level by means of more substantial mechanisms for credit support and shared reserve funds. Policy coordination should also extend to domestic macroeconomic management. And such measures have a greater chance of success if they are implemented regionally and, ultimately, globally.

B. The challenges of global liquidity expansion

1. Liquidity expansions before and after the crisis

Inadequate global demand is a primary problem resulting from the Great Recession that has yet to be resolved. In part, this reflects an ongoing failure to re-link finance to sustainable income generation and spending. In the run-up to the financial crisis of 2008–2009, effective demand in major economies was not supported by a sustained growth of wage income, which is the main factor driving household demand, nor, in most cases, was it supported by rising public sector spending. From the 1990s, fiscal stances were either moderating or being subject to downward adjustments in most of the major economies. The exception was the United States between 2001 and 2004, where extraordinary fiscal injection helped lift the economy after the dot-com crash. In the absence of these two main drivers, GDP growth was based on liquidity creation, initially by monetary authorities and then by private financial institutions (see chapter III). In some of the major economies, this succeeded in boosting demand through asset appreciations and borrowing, leading to consumption booms and private investment bubbles. The counterpart driver in other economies was net export demand. This hazardous configuration of finance and demand was very different from the process of credit creation that sustains production and employment generation.

Likewise, in the recovery from the 2008–2009 crisis, the failure to reverse the long-term deterioration of the wage share, which began in many countries in the 1980s, was compounded by a general shift to fiscal austerity by most developed economies after the brief expansionary episode of 2009–2010. This left recovery almost exclusively dependent on renewed liquidity expansion. However, there are some important differences between the pre- and post-crisis periods that help explain the recent configuration of growth and financial positions across the global economy.

The first and most obvious difference is the post-crisis rise of public sector deficits in developed economies, an inevitable analogue of the unprecedented balance sheet adjustments of banks, businesses and households. The second difference is that this time liquidity creation has been engineered by central banks, unlike during the pre-crisis period when the main trigger for liquidity creation was excessive leveraging by the private (and shadow) banking sector.[3] A third difference, a consequence of the first two, is that liquidity expansion has been channelled through financial sectors as portfolio assets, including in developing countries, and is therefore mostly detached from the real economy.[4]

The latter became apparent in the rise of cross-asset correlations among global equities, commodity markets and currencies in the early 2000s (*TDR 2011*, UNCTAD 2012a). Portfolio allocations between equity and currency markets reflected mostly risk-on/risk-off perceptions, while perceived benefits from diversification drove commodity investment and reduced the link between asset prices and the performance of the underlying real assets, especially between mid-2008 and mid-2013. This contributed to a noticeable rise in volatility across all markets. Since 2013, fundamentals have been more significant in explaining price movements for most primary commodities (see chapter I). In this context, the changing degrees of importance of drivers of price formation in real, financial and foreign-exchange markets have considerably undermined the ability of policies to

influence real economic performance or mitigate external shocks.

As far as DTEs are concerned, their performance, both in the pre- and immediate post-crisis periods, has generally been characterized by a combination of supportive domestic demand and export buoyancy. As a group, they have also enjoyed greater domestic financial stability than developed countries, despite increased liberalization of financial flows and opening up that has allowed a greater presence of foreign banks and investors in their domestic markets. However, global financialization in the absence of sufficient regulation of domestic financial markets has left DTEs more exposed to the consequences of boom-and-bust cycles of capital inflows, as noted in earlier *TDRs* and other studies (Akyüz, 2008 and 2011). Exposure to any shock emanating from external financial cycles could quickly erode the strength of domestic demand in several DTEs, with potential repercussions for the stability of the global economy.

In China, where monetary policy sterilization and reserve accumulation have largely moderated the impact of capital inflows, overindebtedness in sectors linked to the construction boom is becoming a growing concern for policymakers (Chandrasekhar and Ghosh, 2015; Magnus, 2014).[5] Although a slowdown of investment can be expected, if this coincides with a sharp decline in housing construction and infrastructure building, it could contribute to a reversal of the large short-term and equity capital inflows (as detailed below). In other DTEs, socially more inclusive policies have played a relatively effective role in supporting domestic demand by implementing countercyclical fiscal measures, advancing strategic plans for export diversification away from primary commodities (with limited success), socializing gains from commodity extraction, and moderating the effects of excessive capital inflows via reserve accumulation or different forms of capital controls. Nevertheless, there remains a strong possibility that the scope and impact of such policy measures could be insufficient to counter the considerable size and consequent influence of global financial markets. Indeed, the "taper tantrum" of 2013, which generated substantial shocks to performance and deflationary policy reactions in several developing countries, could prove a (mild) harbinger of possible capital reversals to come (Neely, 2014; UNCTAD, 2014). The landscape may be more challenging in DTEs that have not implemented any countervailing policies to manage financialization.

2. The rise and aggregate risks of capital inflows to DTEs

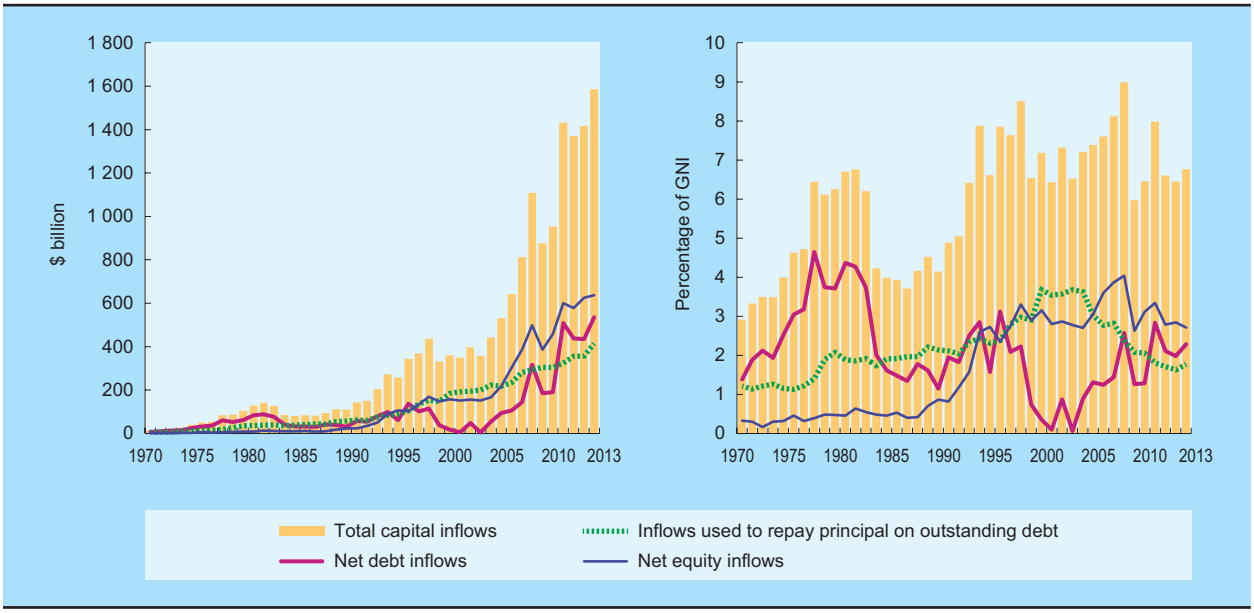
Comprehensive records of external flows and stocks for a large number of DTEs confirm that their exposure to external sources of financing has continued to rise (Chandrasekhar, 2007; Gallagher, 2015).[6] Gross annual debt flows (net flows plus debt repayments) to DTEs reached nearly $1 trillion in 2013. This is about five times more than in 2002, the last significant trough after the sequence of financial crises in the late 1990s and the dot-com crash in 2001, when gross debt flows to DTEs amounted to $204 billion. It should be noted that a rising share of gross annual debt flows is on account of debt repayments, which grew proportionally to the volume of accumulated liabilities over time. However, there was also a huge rise in *net* debt flows (i.e. gross inward flows minus repayments), from $3.5 billion in 2002 to $535 billion in 2013. Net equity inflows into DTEs, which, according to the World Bank's *International Debt Statistics 2015,* comprise portfolio equity as well as direct investment, rose more than fourfold during that period, from $152 billion to $637 billion (chart 2.1).

These increases of external flows to DTEs do not seem so staggering considering that these economies experienced a period of nearly uninterrupted rapid economic growth after 2003, despite being affected to varying degrees by the global financial crisis. Comparisons of the same flow variables noted above as a per cent of aggregate gross national income (GNI) are captured in chart 2.1. By this measure, there was a considerable rise of gross and net debt flows from 2002 to 2007, resuming again in 2010. Particularly for gross flows, the pattern is similar to the boom cycle of the 1990s, though not as dramatic as that of the 1970s which led to the debt crises of the early 1980s. Net equity inflows as a per cent of GNI experienced fluctuations as well, but from a consistently higher level from the mid-1990s onwards. As a proportion of GNI, both sources of external inflows to DTEs together (debt and equity) increased from 2.8 per cent in 2002 to 5 per cent in 2013, after having reached two historical records of 6.6 per cent in 2007 and 6.2 per cent in 2010.

Chart 2.1

FOREIGN CAPITAL INFLOWS INTO DEVELOPING AND TRANSITION ECONOMIES BY COMPONENTS, 1970–2013

(Billions of dollars and percentage of GNI)



Source: UNCTAD secretariat calculations, based on World Bank, *International Debt Statistics* (*IDS*) database.

These aggregate patterns are not unique to the larger DTEs, which have relatively more developed financial and capital markets. Lower-income DTEs[7] may have absorbed a considerably smaller volume of capital flows, but their patterns are similar to those of the group as a whole, showing a clear rise from 2002 to 2013, with peaks in 2007 and 2010. As a proportion of GNI, both sources of external flows to this subgroup of DTEs together (debt and equity) increased from 2.5 per cent in 2002 to 5.1 per cent in 2013, after having reached a historical record of 7.7 per cent in 2007.

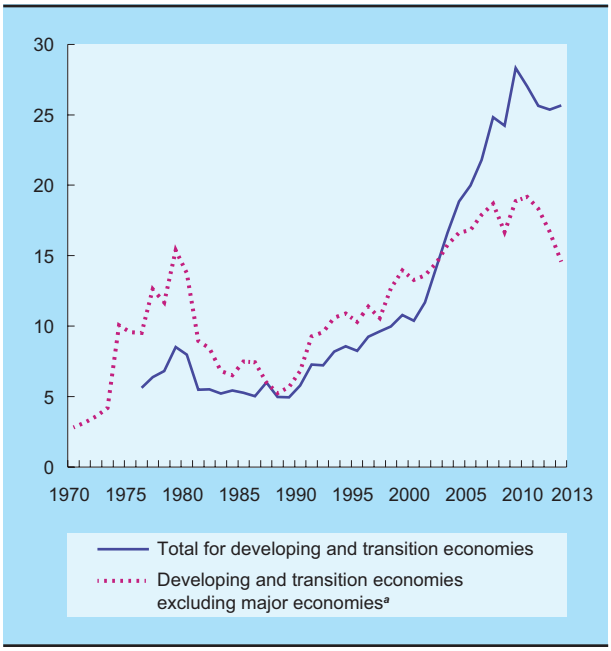
Relative to earlier periods, from 2003 onwards most DTEs experienced strong growth and current account surpluses or lower deficits, suggesting that financing needs for development may not have been the main driver of the boom in capital inflows.[8] Rather, "push" factors like monetary conditions and risk perceptions of developed-country investors, in tandem with stock market appreciations in DTEs, may have been the dominant drivers (see *TDR 2013*, chap. III for a detailed econometric exercise). Not unrelated is the fact that DTEs as a whole, particularly the larger economies of this group, accumulated considerable amounts of external reserve assets during this period (chart 2.2).[9] Under these circumstances, reserve accumulation primarily reflects an excess of inflows over the amounts that would normally be consistent with domestic spending and investment patterns. By 2013, over 40 per cent of the reserves held by DTEs were "borrowed", in the sense of not deriving from a current account surplus, but rather set aside from capital inflows (Akyüz, 2014: 11). While policy makers often see reserve accumulation as a precautionary measure, there are limits to this strategy. Given the levels of inflows and reserve accumulation, an important question is whether these patterns are consistent with financial stability and sustained global demand.

When considering the balance of payments, the focus is often on trade deficits and surpluses, on the assumption that net factor incomes[10] will simply reflect a neutral pattern of capital flows. But the determination and implications of the factor income balance involve a few complexities. First, factor incomes depend on the volume of assets and

Chart 2.2

FOREIGN RESERVE STOCKS IN DEVELOPING AND TRANSITION ECONOMIES, 1970–2013

(Percentage of GNI)



Source: UNCTAD secretariat calculations, based on World Bank, *IDS* database.

a The major economies excluded are Argentina, Brazil, China, India, Mexico, South Africa and Turkey. Also excluded are Algeria, Egypt, Libya, Morocco and Tunisia. The Russian Federation is not in the IDS sample.

liabilities, as well as on their rates of return. In turn, assets and liabilities are accumulated from the outward and inward flows respectively. Second, a current account surplus, by definition, equals a *net* outflow of funds on the "capital and financial account" (hereafter referred to as the "capital account").[11] Conversely, a current account deficit will equal *net* inflows of capital. But this does not mean that an economy will receive precisely the amount of gross inflows that match the current account deficit, or have gross outflows that exactly equal the current account surplus. Rather, inflows and outflows are partly the autonomous result of investors' perceptions, leading to mismatches between finance and the real economy. As noted above, capital inflows in excess of those required to finance a current account deficit end up as residents' private capital outflows or reserve accumulation by a central bank. Likewise, surplus countries which, in addition to their earned foreign exchange from trade, receive large amounts of private inflows end up accumulating "borrowed" reserves.

Taking into consideration that rates of return paid to foreign investors are usually greater than those obtained by private residents or central banks of developing countries, the end result is that the balance of factor incomes often may have a tendency to worsen the current account.[12] For example, rising net (positive) investment positions of surplus DTEs could eventually coexist with declining net factor incomes. These disadvantages are magnified for DTEs with prolonged current account deficits, where the accumulated reserves are mostly "borrowed". Thus, with worsening net factor income imbalances and trade deficits, these DTEs will face growing net liability positions. If deficit DTEs do not succeed in improving their trade performance, they must depend on capital inflows to fulfil their external obligations. By implication, these are extremely fragile "Ponzi finance" schemes, where current liabilities can only be met by greater borrowing, and any small change in circumstances or sentiment, internal or external, can destabilize both the financial system and macroeconomic conditions (Minsky, 2008).

DTEs generally aim at improving trade performance for a variety of reasons related to growth, and technical progress, among others. But the prospects of ever larger net factor payment outflows due to the accumulation of inherited liabilities and unequal rates of return may intensify the search for economic strategies to increase net exports, including by reducing imports.[13]

In sum, the empirical evidence reveals that financialization is associated with a continuing rise of global capital flows to DTEs.[14] Furthermore, DTEs face uneven rates of return on their assets relative to their liabilities. From a global perspective, these patterns combined may be problematic in ways that have not been sufficiently acknowledged. First, economies may find themselves in a situation where a deterioration in their factor incomes account leads to increasing liabilities on Ponzi-finance-type terms. Second, in the current circumstances of sluggish recovery from the crisis, when efforts need to be made to boost global demand, especially by surplus countries, the aim of achieving trade surpluses in order to mitigate net factor income losses creates a contractionary bias.

3. Greater financial integration and increasingly unstable capital flows

Mainstream views on financial integration stress that it will be beneficial for both investors and recipient countries, provided that it takes place within a "sound" macroeconomic framework. Recommended policies for DTEs include reducing government intervention (creating a correspondingly bigger role for financial institutions such as private banks and pension funds) and increasing competition and structural reforms in product and labour markets (Caruana, 2011; Milken Institute, 2014a; OECD, 2011).

By contrast, the analysis here adopts a broader and more critical approach to financialization by emphasizing how both push and pull factors have influenced the re-emergence of risks for DTEs since the financial crisis. These greater risks stem from external as well as domestic conditions. External conditions include excessive global liquidity, driven most recently by quantitative easing in developed countries that was insufficiently matched by an expansion of demand because of fiscal austerity.[15] Within DTEs, risks have tended to stem from macro-financial policies that disregard the importance of domestic financial regulation and underestimate the potentially deleterious effects of speculative bubbles. Therefore this section stresses the composition of portfolio flows as a guide to an assessment of potential risks.[16]

During the course of the past 10 years, the weight of private, non-guaranteed, short-term speculative flows has increased significantly in the external portfolios of many of the larger DTEs (chart 2.3) as well as for all the DTEs taken together, excluding the countries illustrated individually.[17] Chart 2.3 traces patterns of more speculative capital inflows relative to total inflows as a share of GNI; the difference includes mostly long-term or publicly-guaranteed loans to public sector institutions and foreign direct investment (FDI). Admittedly, there are significant differences in terms of initial conditions, behaviour and other factors among such a varied group of countries. Chandrasekhar (2015), for example, stresses the influence of previous and recent financial crises on the direction of countries' policy responses. A case in point is Indonesia, where re-regulation and capital controls in the aftermath of the 1997–1998 Asian financial crisis help explain why capital inflows did not recover until well into the mid-2000s. Another case is that of Argentina, where the amount of net capital flows remained moderate after the 2001–2002 crisis.[18] Other authors, such as Gallagher (2015), propose a mapping of cross-border financial regulations in the wake of the 2008–2009 financial crisis, highlighting the cases of Brazil, Peru, the Republic of Korea and Thailand, which implemented second- and third-generation measures, price-based controls and foreign-exchange regulations respectively.

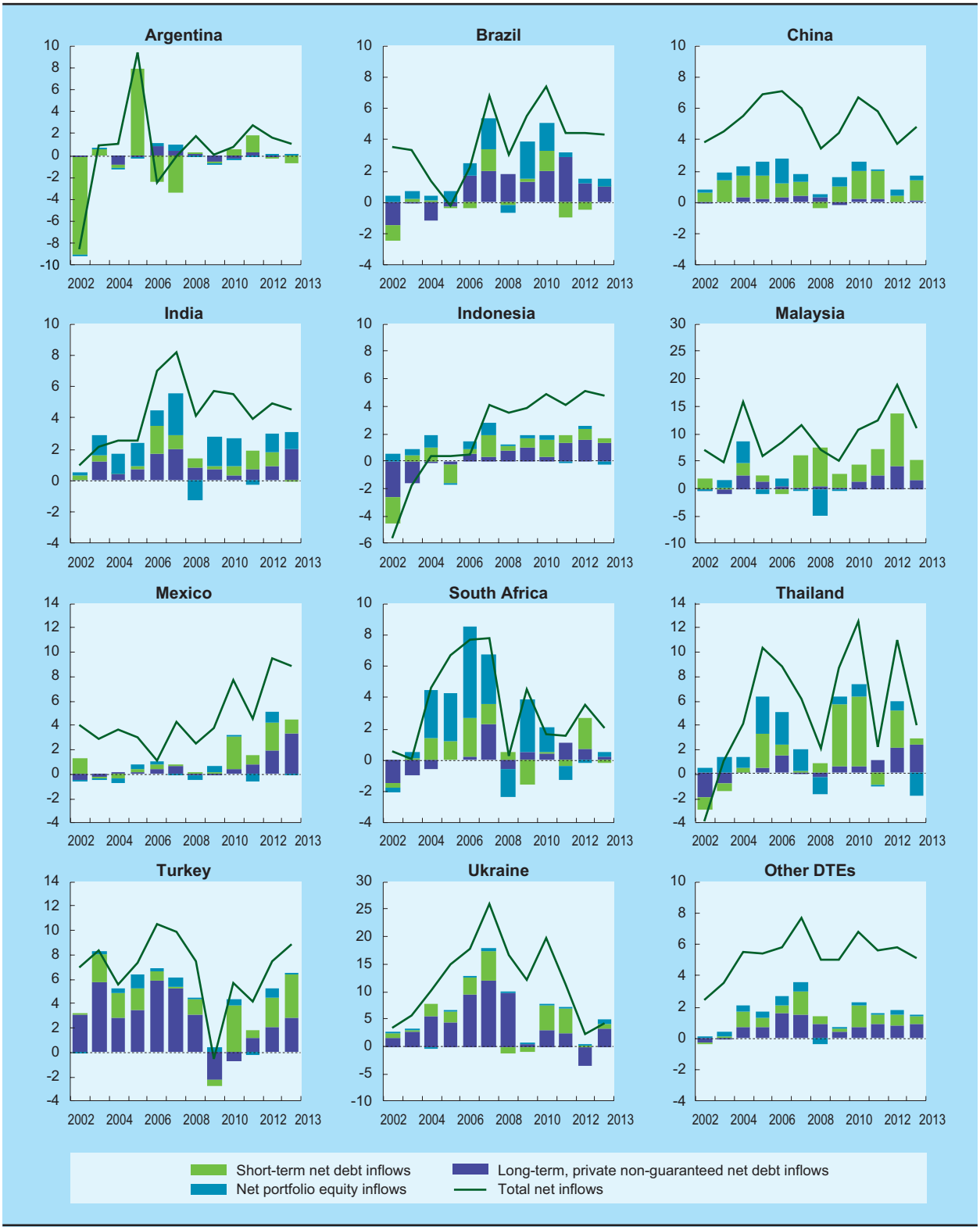
Observations on diversity notwithstanding, the set of countries presented in chart 2.3 shows a considerably large proportion of typically unstable or unreliable flows in the total, strongly driving upswings and downswings, which, in some cases, have been dramatic. Within periods of one or two years, in almost all of these economies the size of net inflows has varied by more than 5 per cent of GNI in either direction, apparently driven by fluctuations in the combination of private, non-publicly-guaranteed debt, short-term debt and portfolio equity (i.e. unstable) flows. In some countries such as South Africa and Turkey (as well as Ukraine until the crisis of 2013), such unstable flows represent almost the totality of inflows, which, combined, can add up to fairly significant proportions of more than 6 per cent of GNI. These flows are even larger for other countries such as India, Malaysia and Thailand. Among the selected sample, only China, Indonesia and Mexico reflect situations where most of the inflows may not be of a short-term or unstable nature. This can be explained, at least partly, by the greater role of regulation in the two former countries.

These patterns represent increasing vulnerabilities for DTEs, not only because of their size relative to GNI, but in particular because of the fact that some markets, such as stock markets, foreign-exchange markets and in some cases even real estate markets, operate in spheres relatively beyond the reach of public policy. These markets are typically unstable and highly correlated with one another, which exacerbates the potential for destabilizing co-movements. And while it may be difficult to measure the size of foreign-exchange markets from the perspective of a single economy, domestic capitalization measures of stock markets are telling: for this sample of DTEs presented in chart 2.3, domestic capitalization is generally considerable, in some cases greater than 100 per cent of GDP (Akyüz, 2014; Milken Institute, 2014b).

Chart 2.3

COMPOSITION OF CAPITAL FLOWS, SELECTED DEVELOPING AND TRANSITION ECONOMIES, 2002–2013

(Percentage of GNI)



Source: UNCTAD secretariat calculations, based on World Bank, *IDS* database.

In many countries and in the DTE subgroup, the gap between the total and the combination of unstable flows includes FDI and non-portfolio equity inflows (chart 2.3). FDI in productive activities, especially in industrial sectors that underpin development, can positively contribute to development.[19] This is particularly the case when FDI in the form of greenfield investments is appropriately absorbed at the national level. However, FDI data in aggregate should be interpreted with caution. For example, the classification of FDI typically refers to the size of the ownership stake (10 per cent or more, according to the IMF), and not to the liquidity of the investment. Indeed, financial innovation and the deepening of financial markets can make large ownership stakes more apparent without significant changes in the liquidity of investments. Another example is the fact that real estate, a highly liquid and volatile sector, attracted the most greenfield FDI in 2014, and of the top 20 recipients, all but 4 were developing countries.[20]

Furthermore, the potential magnitude of factor income payments related to FDI needs to be considered. In 2014, the value of global FDI income exceeded that of all FDI inflows.[21] Economies that are major recipients of FDI may experience the sorts of balance-of-payments instabilities discussed above, since maintaining a sustainable growth path requires generating sufficient foreign exchange to cover external payments, particularly in the context of large profit outflows (*TDR 1999*). If FDI inflows were to slow down, the problem of covering even a modest repatriation of profits could quickly become acute, especially when a large proportion of FDI inflows consists of reinvested earnings and may behave more like portfolio flows than long-term flows (Kregel, 2014b).[22]

This picture of unstable capital flows echoes the experience of many developing countries in the late 1980s and the 1990s (as discussed below). Although the combined share of private, short-term and equity capital flows as a percentage of GNI is now larger than it was in those two decades, at the time, many developing countries started to rely on such forms of financing, since debt markets remained virtually dry after the debt crisis that erupted in 1982. Singh and Weisse (1998), in a critical analysis of the interactions between speculative capital flows and stock markets in developing countries, concluded that the resultant volatility, likelihood of macro-financial shocks, misallocation of resources, and severe disruptions to long-term development goals called into question the argument that developing countries should turn to stock markets as a way of mobilizing resources for sustainable development.

Combining these points on volatility arising from the structure of global capital flows with the aggregate fragilities stemming from countries' balance of payments, this section argues that the expansion of unstable, short-term and speculative flows presents a challenge for using such external finance in ways that could enhance development. The next section takes up the question of the challenges and opportunities for domestic macroeconomic management.

C. The macroeconomic costs of financialization

1. *Effects of unfettered financial integration on prices and policy*

In addition to the macro-financial risks identified above, unstable financial flows to DTEs have effects on key prices, such as exchange rates, and at the same time they constrain monetary and fiscal policies. So-called "balance-of-payments-constrained" growth frameworks provide a basis for understanding the myriad connections and lines of causality between external flows and economic growth. They are based on the insight that to achieve sustained growth it is necessary to balance imports and net factor income payments with exports in a sustainable manner.[23] For instance, the size of the current account deficit or external debt relative to domestic income can limit pathways to stable growth. Policymakers may change

course by either reducing domestic expenditure, and thus imports, or supporting investments that trigger faster output growth, such as by increasing exports (Moreno-Brid, 1998). Alternatively, according to this approach, conditions in international financial markets can determine the extent of foreign financing available, which in turn affects imports and fixed investments, eventually determining the trade balance and the growth trajectory (Barbosa-Filho, 2001).

These relationships are perhaps most immediately apparent in terms of how financial flows, in combination with monetary policy reactions, affect prices. Influencing the real exchange rate to maintain competitiveness and encourage the production of tradables represents a challenge for policymakers in DTEs. Excessive nominal exchange rate depreciation will tend to exacerbate domestic price inflation due to the higher cost of imported capital and consumption goods. Conversely, excessive nominal exchange rate appreciation, when not sufficiently compensated by lower domestic inflation, may create a tendency towards real exchange rate appreciation that has a prolonged effect on the current account. Navigating within these constraints is difficult for central bank policy in developing countries.

Interventions in the foreign-exchange market to avoid an appreciation of the domestic currency lead to monetary expansion, which central banks usually try to sterilize by selling government securities in money markets. However, these operations may not necessarily result in interest rates that are stable and consistent with real demand; generally, the interest rate tends to overshoot and is followed by a drastic fall. A higher interest rate exerts further upward pressure on the exchange rate as foreign investors respond by engaging in interest rate arbitrage. Even assuming that exchange-rate management and reserve accumulation may be helpful in the context of capital inflows, often, this policy is not symmetrical. Authorities usually have greater difficulty coping with capital reversals. Using a large amount of reserves to meet demand for foreign currency can risk eventually emptying the coffers.[24] Usually, money market operations aimed at raising the interest rate are activated.

Independently of whether the central bank is engaged in explicit exchange-rate management, if the behaviour of the central bank is driven by a narrow inflation target rule, there will be a tendency towards nominal appreciation (for further explanation, see Barbosa-Filho, 2012). Inflation-targeting frameworks typically tend to conform to narrow monetarist ideas about the existence of an exogenous supply of money and its impact on inflation. Thus, following surges of capital inflows, monetary authorities may consider it critical to avert an inflationary spiral resulting from the increase in money supply. But capital outflows leading to exchange-rate depreciations can also trigger inflationary pressures via the pass-through effects of import prices. In the context of inflation-targeting, independently of the source of inflationary pressures, the critical instrument to tame the inflation rate is the interest rate, which often brings with it pressure for nominal appreciation. If this effect is stronger than the presumed effect of reducing the inflation rate, a real-exchange-rate appreciation follows, with the potential of a currency crisis if the current account deteriorates significantly. As a matter of fact, high interest rates have perverse effects on price formation, as producers tend to pass on the higher cost of borrowing by raising prices (Lavoie, 2001). The destabilizing effect of speculative capital movements on nominal exchange rates, combined with inflation targeting regimes that aim at high interest rates, may not only create balance-of-payments problems in the short run, resulting from an overshooting and successive corrections of interest rates; it may, in the long run, also translate into slower growth, because real exchange rates tend to remain appreciated in order to avert financial shocks, effectively damaging the current account (Frenkel and Rapetti, 2009).

Chart 2.4 illustrates some of the mentioned interactions between capital flows, exchange rates and short-term policy rates for the same countries shown in chart 2.3. In some cases, the suggested influences of external capital on the macroeconomic environment seem unambiguous. Increases in capital inflows in excess of what is needed to finance real demand tend to exert upward pressure on the exchange rate. This influence may be magnified during commodity price booms for net commodity exporters. Brazil, Malaysia, Ukraine and to some extent India appear to be representative of these patterns, while China is an exception, as the authorities have managed a steady appreciation of the exchange rate. For the entire group of DTEs, the relationship holds quite well despite the high level of aggregation. In other cases (e.g. South Africa and Turkey), the correlation applies only for selective years, while in Thailand the variations in the exchange rate seem to be influenced by the pace of capital inflows over the

Chart 2.4

NET CAPITAL INFLOWS, NOMINAL EXCHANGE RATES AND NOMINAL INTEREST RATES IN SELECTED DEVELOPING AND TRANSITION ECONOMIES, 2002–2013

Source: UNCTAD secretariat calculations, based on World Bank, *IDS* database; IMF, *World Economic Outlook*, April 2015; and IMF, *International Financial Statistics* database.

medium term, with central bank intervention acting over the short term. Argentina shows a steady currency depreciation in nominal terms, resulting not from capital movements (which remained subdued), but rather reflecting its inflation rate and proactive exchange-rate management. In these more ambiguous cases, it seems that other drivers, including some degree of proactive policy management, may be the cause of exchange rate fluctuations. Indonesia, as noted earlier, has for several years maintained varying regimes of exchange-rate management, while the resumption of capital inflows seems to have responded to the commodity boom that started in 2003–2004.

Typically, the correlations between capital flows and exchange-rate cycles are more pronounced in the short term. Indeed, drastic capital flow reversals occurred in mid-2013 in many of the economies discussed here following the announcement by the United States Federal Reserve that it would reduce the pace of quantitative easing. Sharp depreciations followed, and in some economies it took specific monetary policy responses to halt the turnaround. Fears that instabilities of this kind, and perhaps of a greater magnitude, will emerge following a tightening of United States monetary policy are justifiable in view of such experiences. Some short-term monetary policy responses to changes in capital flows are discernible in the annual flows shown in chart 2.4, where decelerations in the pace of capital inflows are followed by interest rate increases – a pattern that is often quickly reversed. In these cases, interest rate fluctuations can be sharp from one year to the next. This volatility may have damaging effects on financial stability and on the environment for productive long-term investment. What is more, because high interest rates are often not sufficiently effective, or may even hamper efforts to control inflation, a resulting tendency towards appreciation of the real exchange rate will have lasting effects on the current account.

To sum up, it appears that, for the most part, the economies shown in chart 2.4, as well as many others, have been adversely affected by the globalization of finance as a result of perverse effects on exchange rates, and volatile and often high interest rates. In some countries, some degree of capital controls may have helped mitigate these effects (Gallagher 2015; Ostry et al. 2010).

Exchange rates, the balance of payments and monetary policy are the most frequently discussed aspects of the macroeconomic consequences of financial flows. However, financialization also may exert general deflationary pressures on national economies, partly as a result of the constraints that open capital accounts impose on fiscal policy (Patnaik and Rawal, 2005; Patnaik 2006).[25] As noted above, in an environment characterized by free and typically unstable financial flows, policymakers cede control over the domestic interest rate, with the result that the rate that prevails is generally higher than what would be appropriate to support domestic capital formation, dampening economic activity and lowering GDP. In addition, financialization and open capital accounts exert macroeconomic pressures that tend to restrict fiscal policy. Interventionist policies and expansionary fiscal stances, no matter how important they are for development, may be a concern for international finance. Whether these sentiments stem from a fear of unsustainable debt accumulation or inflation, or a desire to expand the scope for private investors by limiting the reach of the public sector, or simply from resistance to a proactive role for the public sector, the result tends to be the same: policymakers become apprehensive that government spending may drive finance away (Krugman, 2000; Patnaik, 2006). Recent debates about fiscal austerity and growth reflect both this concern and the prevalence of the idea that public deficits and debt are unequivocally bad for growth, even when the empirical evidence shows otherwise (Herndon et al., 2013).[26] On the revenue side, tax receipts may decline for two related reasons: first, due to lower levels of economic activity associated with weaker public stances; and second due to ongoing pressures to offer international investors favourable tax rates lest they move elsewhere. The upshot is less government activity, which directly reduces national income as a result of limited government spending, but also indirectly lowers productive capacity by restricting the types of public investments in physical and human capital that support private investment and productivity growth.

Furthermore, openness of the capital account, by strongly altering relative prices and demand patterns, may have longer term effects as well, including by creating deindustrialization pressures in DTEs. Given this risk, it is important to consider the interaction between, and sequencing of, liberalization of the capital and current accounts. This has been, in particular, the experience in parts of Latin America and sub-Saharan Africa (dating back to the late 1970s in some countries), where capital account deregulation, which initially led to massive capital inflows and currency appreciations, took place at the same

time as increased openness to trade. The lower cost and greater variety of industrial imports constituted a gain for consumers and a source of imported inputs into production; but they also depressed the relative prices of tradable goods and services (both imported and exported), squeezing domestic profit margins and wages, and lowering domestic investment and employment.

Recent empirical evidence shows how, in economies with less developed manufacturing industries, these conditions can hollow out local capacities (*TDR 2003*; Rodrik, 2015).[27] This has meant lost opportunities for growth and for an expansion of higher quality employment, since industrial growth is essential for both. Indeed, in such cases, there has been an increase in often informal, lower productivity service sector jobs.

Thus, financialization and open capital accounts, and the higher interest rates they often require to maintain stability, compromise domestic investment and the ability of governments to support it, independently of whether any inflows or outflows have taken place (Patnaik and Rawal, 2005; Kregel, 2014c). When inflows or outflows do occur, they can have deleterious effects on industrialization and development in various ways. As discussed above, capital inflows exert pressures for real exchange rate appreciation and elevate the primacy of short-term returns in speculative markets over long-term projects that raise productive capacity (Patnaik, 2003). This makes it more difficult to conduct the type of structurally transformative investments required for development. On the other hand, sudden stops or capital flow reversals can turn deflationary tendencies into contractionary crises, resulting in substantial real economic and human costs and relegating fiscal policy to servicing debt rather than supporting development. The next section uses the recent history of financial crises in DTEs as a guide to determining the consequences of such overexposure to speculative finance.

2. Learning from the past: Public sector finances and economic development after financial crises

As discussed above, financial liberalization and deregulation provide an opening for a surge of capital flows as well as domestic lending, adding to the likelihood of bubbles in stock markets and real estate markets. Such large inflows are often magnified by the way fiscal and monetary policies adapt to investors' expectations. The consequent build-up in financial fragility, driven by largely private speculation and risk-taking, is often swiftly unwound by a crisis, with substantial negative real effects and a sharp rise in public debt. Table 2.1 lists countries and the dates of their currency, sovereign debt or banking crises, grouped by the four waves of financial crises identified: various debt crises in the 1980s, the Mexican crisis in 1994–1995 and its so-called tequila effects, the Asian financial crisis in 1997–1998, and its ripple effects on countries outside the Asian region.[28] It is not a complete list of all of the financial crises that occurred during these periods, but rather a representative sample dictated by data availability and core themes.

Almost all of these crisis episodes listed (31 out of 33) were preceded by a "capital flow bonanza", defined as an unusually large negative surge in the current account balance.[29] Similarly, domestic credit booms preceded crisis nearly 75 per cent of the time (24 out of the 33 episodes listed). In the table, minimum real per capita GDP growth refers to the minimum growth rate within four years of the start of the crisis (including the crisis year, recorded as the earliest year that any of the three types of crises began, and is referred to as time *T*). Its intent is to make inferences, however rough, about the output losses resulting from these crises. The last two columns indicate the costs of the financial crises in terms of the growing public debt, both to domestic and external creditors. Comparing public debt as a share of GDP the year before the financial crisis begins *(T-1)* relative to two years after *(T+2)* for the entire group of crises listed, the median (average) increase in total gross central government debt is 85.9 (124.3) per cent, while the median (average) increase in external government debt is 42 (60.5) per cent. Interestingly, although fiscal mismanagement is a frequent refrain in mainstream accounts of financial crises, it is typically the public fielding of the private bust, and all the costs associated with it (e.g. nationalizing private debt, recapitalizing banks, and the impact of currency devaluation on the value of foreign currency liabilities), that run up public debt.

(a) Lessons of the 1980s

The Latin American debt crises of the 1980s caught many investors and analysts by surprise.[30] The world had not witnessed a major financial

Table 2.1

PERIODS OF FINANCIAL CRISES, CAPITAL FLOWS AND PUBLIC DEBT

Country	Currency crisis (year)	Sovereign debt crisis (default year)	Banking crisis (starting year)	Capital flow bonanza	Domestic credit boom	Minimum annual real per capita GDP growth	Change in total gross public debt as a share of GDP	Change in gross external public debt as a share of GDP
							(Per cent)	
Debt crises of the 1980s								
Argentina	1981	1982	1980	x		-7.1	417.7	53.4
Chile	1982	1983	1981	x	x	-11.7	161.7	106.9
Mexico	1982	1982	1981	x	x	-6.1	95.7	117.9
Uruguay	1983	1983	1981	x	x	-10.9	378.5	302.9
Colombia	1985		1982	x	x	-1.3	71.1	35.2
Ecuador	1982	1982	1982	x		-2.9	60.5	16.0
Paraguay	1984	1982		x		-5.9	78.7	35.5
Turkey			1982	x	x	1.2	83.1	32.7
Venezuela (Bolivarian Rep. of)	1984	1982		x		-6.3	95.2	62.1
Brazil		1983		x	x	-5.6	12.7	39.7
Peru	1981		1983	x	x	-12.5	127.6	73.4
Philippines	1983	1983	1983	x	x	-9.8	n.a.	34.2
Argentina	1987		1989	x		-8.8	111.4	87.7
Peru	1988			x	x	-14.2	146.8	68.7
Venezuela (Bolivarian Rep. of)	1989			x	x	-10.9	43.9	8.8
Brazil			1990		x	-5.9	191.1	32.1
Group median						*-6.7*	*95.7*	*46.6*
Tequila crisis								
Mexico	1995		1994	x	x	-7.6	26.4	47.0
Argentina			1995	x	x	-4.1	14.5	41.3
Group median						*-5.9*	*20.5*	*44.2*
Asian financial crisis								
Indonesia	1998	1999	1997	x	x	-14.4	246.0	100.9
Republic of Korea		1998	1997	x	x	-6.4	278.8	65.3
Malaysia	1998		1997	x	x	-9.6	7.1	38.1
Philippines	1998		1997	x	x	-2.7	10.4	42.5
Thailand	1998		1997	x	x	-11.5	597.7	28.0
Group median						*-9.6*	*246.0*	*42.5*
Ripple effects from the Asian financial crisis								
Colombia			1998	x	x	-5.8	117.5	20.8
Ecuador	1999	1999	1998	x	x	-6.6	49.9	28.9
Russian Federation	1998	1998	1998	x		-5.1	39.5	96.4
Ukraine	1998	1998	1998	x			70.0	n.a.
Brazil	1999			x		-1.2	-15.2	46.1
Turkey	2001		2000	x	x	-7.1	144.4	35.1
Argentina	2002	2001	2001	x	x	-11.7	208.1	149.9
Paraguay	2002					-2.0	-3.3	18.5
Uruguay	2002	2002	2002	x	x	-7.8	88.6	60.7
Venezuela (Bolivarian Rep. of)	2002			x	x	-10.5	22.5	10.1
Group median						*-6.2*	*60.0*	*35.1*

Note: *Country and crisis listings*: Countries are listed in order of earliest crisis year of the three types of crises listed, referred to as time *T*, and then alphabetically; source for dates of the currency, debt and banking crises is Laeven and Valencia, 2008.
Capital flow bonanza: An "x" indicates that a capital flow bonanza occurred within any one of three years preceding the earliest crisis date; source: Reinhart and Reinhart, 2008.
Domestic credit boom: An "x" indicates that a domestic credit boom was identified preceding time *T* in one of three sources: Arean et al., 2015; Elekdog and Wu, 2011, or Takáts and Uper, 2013.
Minimum real per capita GDP growth: This refers to the lowest annual growth rate within four years of the beginning of the crisis (i.e. the range is time *T* to (*T*+3)); source: World Bank, *World Development Indicators* database.
Public debt: Total gross central government debt includes both domestic and external debt. Total gross external government debt includes all external debt owed to both the public and private sectors. Percentage changes are based on UNCTAD secretariat calculations; source: Reinhart and Rogoff, 2010a, except for data on Ukraine, which is from de Bolle et al., 2006, and percentage changes are based on UNCTAD secretariat calculations of the change between (*T*-*1*) and (*T*+*2*).

crisis since the 1930s, commodity prices were high and real interest rates low. Flush with petrodollars, many developed-country banks provided financing to (mostly private) borrowers in developing economies as an alternative to the lacklustre investment opportunities at home. The fact that the loans were overseen by banks (and not based on bonds) was supposed to enhance information and oversight, adding to the general sense of confidence and optimism that prevailed (Reinhart and Rogoff, 2009). Many developing countries used these funds to cope with oil price shocks, maintaining growth in the face of mounting balance-of-payments constraints; even oil exporters borrowed heavily, drawn in by international lenders eager to extend loans (Palma, 2003). At the policy level, a number of Latin American countries introduced financial deregulation and trade liberalization in the 1970s, especially those in the Southern cone (Argentina, Chile and Uruguay).

Beginning in 1979, there was a series of global economic shocks involving real interest rate hikes. These were a consequence of United States efforts to tame inflation, intensified recession in developed countries and a fall in non-oil commodity prices. As a result, optimism swiftly gave way to panic. The cut-off in lending, balance-of-payments crises and devaluations that ensued led to a cascade of defaults (see table 2.1 for a partial list). In response to the alarming spectre of widespread bankruptcies, Latin American governments nationalized what had been largely private debt, with renegotiation and servicing orchestrated by international financial institutions on the condition of implementing stabilization and structural adjustment programmes (Díaz-Alejandro, 1985; Younger, 1993; Damill et al., 2013).

Looking back at this period, there were several reasons to be critical of domestic policy choices, such as liberalizing domestic financial markets without implementing adequate oversight, or underestimating the deleterious effects of real-exchange-rate appreciation in the context of trade liberalization. But DTEs' domestic policies and economic structures varied much more than critics typically emphasized. For instance, some Governments had relatively interventionist models of economic governance (e.g. as in Brazil), while others engaged in more free market reforms, including financial liberalization (e.g. as in Argentina, Chile and Uruguay). A third set had open capital accounts but imposed limits on private sector access to external finance (e.g. as in Mexico and the Bolivarian Republic of Venezuela) (Díaz-Alejandro, 1984). What these countries did share were the same external economic conditions that generated capital flow bonanzas in the years leading up to the crisis, a consequent build-up of financial fragility, and the inevitable crash that followed on the heels of common economic shocks (Stiglitz, 2003).[31] Explicit and implicit public guarantees of private debt then transformed the crises into sovereign debt problems.

Predictably, given the dominant economic paradigm of the era, early economic models that grew out of the experiences of the 1980s debt crises focused primarily on the challenges of "fiscal sustainability", and how fiscal deficits and expansionary policies, for instance, made economies vulnerable to speculative attacks in the context of effectively fixed exchange rate regimes (e.g. Krugman, 1979; Obstfeld, 1994). Accordingly, government missteps could generate a loss of investor confidence, inducing a self-fulfilling prophecy as investor fears would fuel the currency depreciation that had sparked their unease in the first place (Krugman, 2014). The conventional wisdom that emerged emphasized getting a country's fiscal house in order, and letting markets do the rest (Calvo, 2005). This perspective was also reflected in the policy prescriptions associated with structural adjustment, which accorded priority to servicing debt and required liberalization and privatization.

(b) The return of capital flows to Latin America

In 1989, Mexico signed on to the United States Government's Brady Plan, which was designed to further encourage free market reforms and ease debt burdens by converting government debt into bonds collateralized by United States Treasury bills. A number of other countries swept up in the 1980s debt crisis soon followed Mexico's example. This marks the beginning, particularly in Latin America, of the era where the Washington Consensus on economic policy dominated much of the thinking on how to manage global integration and the domestic economy, including strong commitments to financial liberalization and privatization (Damill et al., 2013). These reforms and debt restructurings eased concern over fiscal debt, alleged as to be the key policy mistake of the 1980s, and reopened access to international capital for debtor countries.

Attracted by relatively high rates of return, and reassured by domestic policy reforms and the prospect of a satisfactory conclusion of the negotiations on the North American Free Trade Agreement (NAFTA), portfolio investors herded into Mexico, driving booms in domestic credit (helped by the privatization of commercial banks) and stock prices, but this did little to boost real GDP growth (Grabel, 1996). In 1994, an increase in interest rates in the United States, as well as a series of destabilizing political events, ended the capital flow bonanza and necessitated the drawing down of reserves in order to finance the substantial current account deficit (Moreno-Brid and Ros, 2004). International investors became concerned that Mexico's exchange rate, which was essentially pegged to the United States dollar, was headed for devaluation. As these self-fulfilling crises typically work, the consequent capital outflows induced the currency crisis that investors had feared. In the lead-up to the crisis, Mexico's increasing reliance on dollar-denominated debt instruments called *tesobonos* introduced additional risks, stoking investors' fear of default and crisis (Lustig, 1995). The Clinton Administration helped secure a quick bailout that gave priority to bond repayment and furthered neoliberal reforms (FitzGerald, 1996; Grabel, 1996).

The Mexican crisis created devaluation pressure among a number of other emerging markets as worried investors re-evaluated risk in the context of fixed exchange rates (the so-called "tequila effect"). The strongest impact was felt in Argentina. In early 1991, Argentina had established a currency board, which maintained a fixed peg of its currency to the United States dollar and established that the monetary base would be entirely covered by international reserves (an arrangement that persisted to 2001, when the crisis that the scheme helped to build finally erupted). While the regime was effective at curbing high inflation, the liberalization of trade and finance led to an appreciation of the real exchange rate, increasing current account deficits and external debt (Damill et al., 2013). When the Mexican crisis struck, Argentina also faced sudden capital outflows, mainly from residents' deposits in domestic banks. The pressure on Argentina's banks proved too strong, forcing the government to negotiate a bailout agreement with the IMF in 1995. IMF support, which was conditional on the Government tightening its fiscal policy by increasing taxes, opened the way for significant foreign financing of government debt (Calcagno, 1997; Boughton, 2012). Brazil avoided a similar fate largely by raising short-term interest rates, which introduced other fragilities (i.e. persistently high interest rates, including on public debt) that rendered it susceptible to crisis later in the decade (Palma, 2011).

Though limited in scope and relatively short-lived, these crises challenged some of the conventional wisdom on the determining roles of fundamentals and liberalization, as well as the reputation of some of the "star students" that had followed this policy advice (Boughton, 2012: 487–488). There were some efforts to suggest the lack of domestic savings as an insufficiently recognized vulnerability, but the spectacular savers caught up in the Asian financial crisis a couple of years later quickly undermined that line of reasoning (Calvo, 2005). A more enduring alternative explanation, for what would become a common neoliberal "exceptionalism" story, laid the blame for the crisis squarely on the Mexican Government for economic mismanagement, political overreach and corruption (Grabel, 2006). Echoes of this reasoning would reappear to try and explain the Asian financial crisis.

(c) The Asian financial crisis and beyond

If the Mexican crisis caught many by surprise, the Asian financial crisis came as a veritable shock. Most of the region's macroeconomic fundamentals seemed indisputably sound: growth and savings rates were high, and since fiscal policy was generally conservative, most borrowing was private. In 1996, the year before the crisis hit, current account deficits in Malaysia and Thailand were on the large side,[32] and the region's overall growth had declined slightly, but none of this really justified the extreme alarm and consequent dislocation that would soon follow (Krugman, 1999).

As with other crises, the pathway to the Asian financial crisis began with financial liberalization, both on the capital account and in domestic financial markets (Montes, 1998). These reforms were partly in response to pressure from domestic firms and banks, which were eager to access lower interest loans in global capital markets for investments at home; and large institutional investors in developed countries were happy to oblige (Wade, 1998). South-East Asian governments caved in to the pressure, and, in some cases, had developed vested interests in

allowing property bubbles to grow (Wade, 2004).[33] The practical result was widespread expansion of private lending, much of which was linked to short-term, hard-currency-denominated debt instruments (Grabel, 1999). At the same time, capital inflows were associated with higher rates of inflation and real exchange rate appreciation, leading to a loss of international competitiveness and worsening current accounts (Chandrasekhar and Ghosh, 2013). These changes drove even more investors into the real estate and stock market bubbles, especially in South-East Asia. With growing signs of weakness in Thailand's asset markets by 1995, and global capital starting to shift away from emerging markets as the United States Federal Reserve raised interest rates in March 1997, investors became increasingly worried that Thailand's pegged exchange rate would not hold (Wade, 1998). The Thai central bank, after unsuccessfully using its reserves to defend the baht against speculative attacks, finally let the currency float in July 1997. The baht's consequent depreciation spooked investors, setting off contagion first to neighbouring economies in South-East Asia (Indonesia, Malaysia and the Philippines), and then to Hong Kong (China), the Republic of Korea and Taiwan Province of China.[34] The IMF swiftly moved in to help contain the crisis, pushing an agenda that has since been criticized for possibly worsening the contagion and deepening the crisis (Radelet and Sachs, 2000), as well as over-reaching in its imposition of market-oriented structural reforms (Crotty and Lee, 2004; Stiglitz 2002).

Outside Asia, the Russian Federation was next to be pulled into a crisis. Soon after liberalizing finance and allowing more foreign participation in its stock and public bond markets, the Russian Federation faced an increasingly widespread reversal of capital flows to emerging markets – initially led in the Russian Federation's case by the exit of investors from Brazil and the Republic of Korea in response to the Asian financial crisis (Pinto and Ulatov, 2010). Declining commodity prices further compromised the ability of the Russian Federation to defend its fixed exchange rate, resulting in devaluation and default in 1998. The large private sector losses (both domestically and among international investors) generated by the Russian crisis induced a sudden stop of capital flows to Latin America, which manifested as a series of financial crises and low growth that came to be dubbed the "lost half-decade" of 1998–2002 (*TDR 1999*; Calvo and Talvi, 2005).

The experiences of Argentina and Brazil illustrate these dynamics and their links with vulnerabilities established in prior crises. Brazil's system of public financing was severely weakened by its efforts to weather the tequila crisis, where in addition to raising interest rates, a banking sector restructuring loaded the Government with lots of additional debt. The economic slowdown and very high interest payments caused Brazil's internal fiscal debt to soar between 1994 and 1998, with interest on public domestic debt amounting to 3.4 per cent of GDP in 1994 and 7.3 per cent of GDP in 1998 (*TDR 1999*; Sainz and Calcagno, 1999).[35] Defending the currency peg in light of the sudden stop in capital inflows and insufficient reserves became quickly untenable, and currency crisis and devaluation ensued in early 1999. In Argentina, with unsustainable exchange rates, any economic growth increased its trade deficit, but the lack of growth led to a fiscal deficit: neither of these deficits was consistent with the convertibility regime. This contradiction could be circumvented as long as external financing kept flowing. However, when that stopped, tough fiscal austerity and IMF assistance could not prevent an economic implosion, a run on deposits and a partial default on public debt (Calcagno, 2003; Calvo and Talvi, 2005; Damill et al. 2013; Grabel, 2006). Real average annual per capita GDP growth in Argentina sank to -4.2 per cent during the lost half-decade, while the average for Latin America as a whole was 0.2 per cent.[36]

(d) Public sector finances in the context of financial liberalization and systemic risk

This brief review clearly suggests that the likelihood of financial crises increased as DTEs liberalized their capital accounts and domestic financial markets, which led initially to surges in capital inflows and then to the sudden stops or reversals that almost always ensue.[37] And although capital flow bonanzas increased in tandem with free market policy stances in developing countries, they continued to be significantly driven by circumstances external to the economies that hosted them, such as changes in global commodity prices or in United States interest rates, or by the psychological and economic contagion effects of crises elsewhere. These external forces interact with domestic macro policy and structure in ways that raise overall fragility and risk. But domestic factors are only significant when they exist within a larger global financial system characterized by

Table 2.2

FINANCIAL CRISIS AND PUBLIC DEBT IN MEXICO, THE RUSSIAN FEDERATION AND ARGENTINA

(Per cent)

	Total gross public debt as a share of GDP			*Total gross external public debt as a share of GDP*		
Country (crisis date)	*Reference level*	*Pre-crisis growth*	*Post-crisis growth*	*Reference level*	*Pre-crisis growth*	*Post-crisis growth*
Mexico (1994)	42.6	-29.2	26.4	37.3	-10.7	47.0
Russian Federation (1998)	30.2	34.1	39.5	31.0	4.0	96.4
Argentina (2001)	37.6	19.8	208.1	47.9	6.2	149.9

Source: UNCTAD secretariat calculations, based on data from Reinhart and Rogoff, 2010a.
Note: Time *T* refers to the crisis year in parentheses. The columns refer to the following:
Reference level is debt as a share of GDP at (*T-3*);
Pre-crisis growth refers to the percentage change between (*T-3*) and (*T-1*);
Post-crisis growth refers to the percentage change between (*T-1*) and (*T+3*).

too much liquidity and not enough macroprudential regulation, riding on waves of optimism, excessive private risk-taking and over-borrowing that precede the inevitable crash – a dynamic that is endemic to the financial system itself (Minsky, 1992).

The largely private risk-taking associated with financial liberalization then becomes a public debt problem. The most proximate reasons involve the explicit and implicit guarantees that governments provide on private liabilities and the nationalization of bad private debts. But a financial crisis also systematically reduces public revenues and wealth through the effects of exchange-rate depreciation on public assets and liabilities, increases in real interest rates, declines in real output, and the additional borrowing required to deal with the costs of the crisis (de Bolle et al., 2006). Although sovereign defaults are a common feature of financial crises in DTEs, contrary to the common rhetoric around development macroeconomics, in the cases analysed, large public debt is most often a consequence, not a cause.

Even among countries such as Argentina, Mexico and the Russian Federation, where public debt was identified as a major source of the financial fragility that pushed their economies into crisis in the 1990s, there is ample room for qualification. Table 2.2 takes a closer look at public debt for these three countries in their respective pre- and post-crisis years. Reference level refers to public debt as a share of GDP three years prior to the crisis date *(T-3)*, and pre-crisis growth to the percentage increase in that level over the three years leading up to the crisis. By way of comparison, the growth in public debt after the crisis presented in table 2.1 is repeated here. Total and external public debt as a share of GDP for Mexico was actually on the decline before the crisis, while the pre-crisis debt levels of the Russian Federation and Argentina certainly did not portend the crises that followed. However, these figures do not capture how the structure of debt makes DTE governments more vulnerable than their debt levels suggest (e.g. the extent of foreign-exchange-linked liabilities and short-term maturities). Even then, there are arguments to be made about the respective roles of fiscal profligacy versus having to bend to the rules of global financial markets.

3. Looming losses: Fiscal stance, macro policy and aggregate demand

This chapter shows that exposure to unregulated and large financial flows alters macroeconomic developments in ways that can lead to a slowdown of GDP growth as well as unstable internal dynamics marked by sudden shifts of income and wealth between the main sectors (private, public and external). A convenient way to map these shifts and their relationship with economic growth is by using the "demand stances" framework (see Godley and Cripps, 1983; Godley and McCarthy, 1998; and

Taylor, 2001 and 2006). This framework reasserts the Keynesian principle that sustained growth requires continuously increasing injections (which, in simple macroeconomic terms, include private investment, government expenditure and exports) into the flow of income. These injections, in turn, require a steady growth of leakages (measured by the propensity to save, the tax rate and the import propensity), which over time ensure financial stability, as credit rises along the circular flow of income. Thus GDP growth can be explained as the growth, along stable norms, of injections relative to leakages; these eventually determine financial transfers between the main sectors. Such ratios of injections to leakages are termed stances and provide a measure both of demand drivers and financial balances.[38]

Therefore, a useful way to assess changes in behaviour is to trace the patterns of the three stances (fiscal, private and external) along the path of growth. Each of the three stances can be observed relative to GDP in order to see which components of aggregate demand are contractionary and which provide stimulus to the economy. Weaker fiscal stances (declines in government expenditure relative to the tax rate), weaker private stances (declines in investment relative to the savings propensity), and weaker external stances (declines in exports relative to the import propensity) adversely affect the growth path and may generate financial imbalances that increase financial instability.

Applying this framework to the crises discussed in the previous section and listed in table 2.1, we find that in two thirds of these cases, the leading source of demand shifted away from the domestic stances (private and government) before the crisis, and towards the external stance after the crisis.[39] This reflects a tendency, post-crisis, for external accounts to go into surplus while domestic sources of demand taper off. Structural trends and cyclical effects jointly come into play. Current account liberalization prior to a crisis, along with financial inflows and strong exchange rates, allow an expansion of domestic demand with substantial import leakages. After a crisis, wage compression and lower profits, along with fiscal contraction and interest rate hikes to attract capital inflows, weaken private sector stances and lower imports. Stronger external stances mostly derive from a decline in domestic demand and the consequent swift reduction of imports. Regarding the domestic sectors, the triggers are a shift towards deleveraging of households (higher saving propensities) and a contraction of government expenditure when austerity is applied (particularly after private sector losses are transferred to the public sector and fiscal imbalances grow as a result). Further, depreciation of the exchange rate can frequently make the foreign sector the leading source of effective demand without any substantial increase in real export capacity.

Two additional considerations serve to highlight the usefulness of the framework described above to trace demand drivers in some DTEs after the crisis: (i) the buffer role played by commodity export revenues, and (ii) changing views on countercyclical fiscal policy among DTEs. Rising commodity prices (a trend now in reversal) have sustained – at times narrowly – private sector profitability, preserving optimism in the face of ongoing financial volatility. In addition, when growth across the South decelerated in 2009 due to a contraction of exports to the North and the sudden stop of capital inflows, countercyclical policy responses made a recovery possible in 2010 (Grabel and Gallagher, 2015). Despite these ephemeral reversals on countercyclical policy conventions, powerful financial market institutions maintain their biased, short-term perspective which hangs on the importance of financial ratings (see also chapter IV). A policy aversion to providing a strong fiscal stimulus has been the rule. Fiscal orthodoxy and an excessive reliance on monetary policy have generated financial fragility and exchange-rate instability in major developing economies (Akyüz, 2013). Susceptibility to financial pressures is heightened either when public sectors incur debt directly or, as is more frequently the case, circuitously when increased liquidity generates private sector debt that is ultimately taken on by the public sector. Interest payments on debt, whether public or private, further dampen domestic stances.

To summarize, the most important elements that were present in previous crises and which persist today are: open capital accounts; hot money cycles worsened by monetary expansion in developed countries and a consequent rise in external and internal debt (in particular short-term debt); a shift away from deepening industrial development; and constraints on using fiscal policy as a tool for structural transformation and industrial expansion, as monetary policy continues to promote the deflationary trends favoured by global financial investors. Very broadly, these features apply to many countries today to varying degrees, depending on their financial

flows, stocks of debt, and movements in exchange rates and interest rates. Clearly, the most vulnerable economies are those where domestic activities are highly concentrated in only a few sectors.

D. Concluding policy discussion

The analysis in this chapter has focused on the reshaping of global financial markets, leading to the Great Recession and its aftermath to the present day. The extraordinary growth of unregulated global financial markets, in tandem with weaker domestic regulation in most DTEs, has exacerbated the vulnerabilities of these countries, rather than providing increased financing for development needs (discussed in chapter VI of this *Report*). The chapter has stressed that excessive private capital inflows, particularly those of an unstable or speculative nature, affect the configuration of net factor payments, exchange rates, interest rates and other prices, and influence monetary and fiscal policy stances in perverse ways. When DTEs face the threat of sudden stops or capital flow reversals as conditions in global markets change, the results can be even worse. It is clear from the discussion that under these circumstances, policymakers' search for alternatives to ensure more stable outcomes is becoming increasingly challenging.

A significantly more stable macroeconomic environment for development is implausible without collective efforts to reform the international monetary and financial architecture, the subject of chapter III. Nevertheless, there are a number of options that still remain within the purview of national policy. To be clear, none of the proposed recommendations call for delinking from the global economy in terms of either trade or finance, but rather for better managing the links to promote development.

One set of critical policy choices rests on the ability to influence the exchange rate. While avoiding "corner solutions", such as fixed exchange rates or fully liberalized exchange rates, some sort of managed float remains an attractive option (Ghosh, 2007; Damill et al., 2013). The management of the exchange rate (as described by these authors and others) with a view to guiding its evolution as a tool for development entails combinations of monetary policy, central bank operations and incomes policies. How this is achieved in practice depends on the particular circumstances in each country, including their institutional diversity and their balance sheets.[40]

As discussed above, guiding the evolution of the real exchange rate in an environment of large and deregulated global finance, and a global exchange system dominated by a few reserve currencies, will be extremely difficult without some degree of management of the capital account. The possible use of capital controls as a tool for development and financial stability has gained greater acceptability by many governments and international organizations in recent years. Indeed, UNCTAD has been a long-standing advocate of such a policy: in the early 1990s, it suggested that DTEs should consider measures that "discourage capital flows that were not related to real investment or to trade transactions but were motivated by short-term gains" (UNCTAD, 2012b: 50). These and complementary recommendations aimed at restoring stability and averting systemic crises are even more relevant in today's context, as also evidenced by developed countries severely hit by the Great Recession and its aftermath. Again, the circumstances and scope for action differ from country to country, as does the degree of regional coordination required to ensure success.

In an effort to avoid the currency and interest rate risks historically associated with external debt, DTEs have also shifted more of their borrowing from debt denominated in foreign currencies to one denominated in domestic currency.[41] But not all

developing countries can attract international investors to domestic securities markets. And even when they do, there is the additional risk that larger shares of debt, regardless of currency denomination, will be held by more internationally mobile investors. Recent evidence bears out this warning: greater foreign participation in domestic currency sovereign bond markets has been associated with heightened volatility as a result of increased exposure to global financial shocks (Ebeke and Kyobe, 2015).

A similarly mixed result is seen in the growth of international reserves among DTEs. The build-up of reserves is in principle mostly precautionary, in the sense that it is expected to guard against a host of ills introduced by large and speculative international capital inflows and the negative economic and social consequences of their sometimes sudden or substantial departure. Precautionary reserve buffers also hedge against the loss of policy autonomy that often accompanies IMF-type bailouts or against pressures to provide the macro policy conditions preferred by international financial investors (Grabel, 2006). But even if reserve accumulation does offer some protection, providing some policy space to countries whose currencies are under attack, there is an opportunity cost to tying up development resources in this manner. Furthermore, when policymakers try to counter capital flow reversals through the use of reserves, they often end up resorting to complementary measures, such as interest rate increases, as the stock of reserves declines. These policy responses ultimately weaken the economy and erode confidence even further. As noted above, such trade-offs pose a challenge to central bank policy.

In considering policy options, central banks in DTEs should carefully evaluate the implications of narrowly applied inflation-targeting regimes. Pressing too hard to achieve inflation rates deemed desirable more often in developed-country contexts could easily lead to high interest rates and appreciation of the real exchange rate, both of which discourage productive investment and hence development. Still, the widespread (formal and informal) adoption of inflation targeting by some developing countries' central banks reflects real apprehension over any hint of inflation, given their histories of high inflation. But probably more important is the widespread belief that inflation targeting regimes give more credibility to the central banks that implement them, lowering expectations of inflation and enabling higher employment rates for a given level of inflation. However, the empirical evidence does not support the credibility argument (Epstein, 2007). Indeed, stable price formation processes and sustained increases of high-quality employment in a developing country context are complex goals that require attention to the overall stability of credit and financial flows.

But central banks can do more than only maintain price stability or competitive exchange rates to support development, as attested by the historical record. After the Second World War, central banks in Europe and Japan used interest rate ceilings, subsidized credits and credit allocation policies to guide reconstruction and facilitate industrial upgrading (Epstein, 2015). Similar policies were followed by the newly industrializing countries in the second half of the twentieth century, where central banks provided key support to development banks and their governments' fiscal policies (Amsden, 2001; *TDR 2013*). Price stability goals can still help guide these types of policy choices, as when targeted or subsidized credit encourages productivity and employment growth rather than activities that generate inflationary pressures (Epstein and Yeldan, 2009), or when incomes policies ensure that wage growth tracks productivity growth.

However, as evidenced by the failures of developed economies to fully emerge from the recent crisis, monetary policy alone is not sufficient. Proactive fiscal and industrial policies are essential for generating the structures and conditions that support domestic productivity growth and the expansion of aggregate demand. Maintaining strong and stable fiscal stances can help increase production and incomes, generate high-quality employment, and encourage a more egalitarian distribution of income (which exerts a further positive effect on aggregate demand). Policies that ensure that wage incomes increase concomitantly with productivity growth enhance these mechanisms. By extension, trade policy also needs to be aligned with domestic goals and policies for productivity and wage growth, including in global, regional and bilateral trade negotiations (see *TDR 2014*).

These circumstances highlight the need for more effective international policy coordination. Given the sheer size of global capital flows, individual countries' management measures, such as capital controls, exchange rate management, central bank policy consistent with strategic development needs,

and a tighter regulation of domestic financial systems, may not be enough. Domestic policy options should be supplemented by global and regional measures that discourage the proliferation of speculative financial flows. In addition, more substantial mechanisms could be established for credit support and shared reserve funds at the regional level. At the same time, implementing countercyclical macroeconomic policies, improving income distribution and extending fiscal space for development purposes have a significantly greater chance of success when applied also by partner countries, and effectively, the world at large. Indeed, domestic policy stimuli, when applied by only a few countries, are considerably weakened when the inertia of macro policy orthodoxies prevails in partner countries.[42] Such conditions can even yield perverse effects if global investors and international financial institutions respond in ways that generate greater volatility and uncertainty. These aspects are discussed further in the next chapter.

Notes

1 Although middle-income countries tend to be more integrated into the global economy, and as such, seemingly more exposed to the effects of financialization, the magnitudes of capital flows relative to GDP and their macroeconomic effects discussed in this chapter apply to all DTEs (see section B.2 for more detail.)

2 Among a group of 26 developed countries, all but 4 (France, Japan, Sweden and Switzerland) had contractionary fiscal stances relative to their long-run trend between the second quarter of 2010 and the fourth quarter of 2013 (*TDR 2014*, chart 2.1).

3 See Chandrasekhar (2007) for an analysis of factors that led to an explosion of global liquidity creation by private agents after the 1997 Asian crisis, which was transmitted to developing countries through the operations of hedge-funds, foreign direct investment in the form of portfolio equity and increased mergers and acquisitions.

4 Think tanks providing analytical insights for international investors trumpeted the potentially attractive returns of developing economies. See, for example, Accenture, 2012; Black Rock, 2011; Credit Suisse, 2011; Economist Intelligence Unit, 2011; UBS, 2012; and Ahmed and Zlate, 2013, for a more rigorous analysis of factors determining the relative attractiveness of emerging market economies as investment destinations. (The latter study also evaluates the influence of the unconventional monetary policy of the United States as a factor in the composition of flows, a large proportion of which are portfolio allocations.)

5 The crash in China's stock market in June–July 2015, and the Government's responses to it, echo these worries (*Bloomberg Business*, "China stocks plunge as State support fails to revive confidence", 8 July 2015).

6 The World Bank's *International Debt Statistics 2015* contains records of 125 countries, of which 121 are DTEs according to the United Nations classification. Unless otherwise specified, the empirical discussion refers to this group of 121 DTEs. Elsewhere in the chapter the term DTEs refers to all developing and transition economies.

7 These are identified as all the 121 DTEs minus Algeria, Argentina, Brazil, China, Egypt, India, Mexico, Morocco, South Africa, Tunisia and Turkey.

8 There are a few exceptions among DTEs where current account deficits in the 2000s were significantly larger than those in the 1990s, including, most notably, India, South Africa and Turkey.

9 Even countries with a current account surplus obtained additional financing to manage their portfolios, increase their asset accumulation buffers in view of uncertainties, and cope with intertemporal inconsistencies (since expected expenditures are decided in advance of earned income), or even for financial speculation purposes.

10 The current account is the sum of the trade balance and the balance on transfers and net factor incomes. Net factor incomes are primarily the earnings on outward investments and loans less payments made to foreign investors and creditors. Remittance flows from residents working abroad are also accounted

as factor incomes and for some DTEs (e.g. India, Mexico and the Philippines) the size of such flows is substantial.

11 Any statistical errors between the current and the capital and financial accounts in the balance of payments are captured by the "net errors and omissions" category; this item is used to preserve the accounting principle of equality between the current account and the capital and financial accounts.

12 The discussion that follows draws from the analytical framework developed by Kregel, 2014a.

13 In theory, the situation for surplus countries exposed to unfettered capital flows would present similar challenges. Even they could face declining trends in net factor incomes, and therefore downward pressure on their current accounts. Aside from other factors driving their export successes, the prospects of falling net factor incomes might generate pressure to compensate by aiming at ever greater trade surpluses.

14 While the aggregate perspective taken in this section is critical for pinpointing the macrofinancial implications of capital flows in the current context, the detailed analysis below sheds a different light by distinguishing between more unstable and speculative short-term flows and those that are longer term and more likely to be better linked to development needs.

15 This configuration of policies is found, for instance, in the United States, the eurozone and the United Kingdom, and only partially in Japan where quantitative easing was accompanied by some degree of fiscal relaxation. See *TDR 2014* for an extensive analysis.

16 This perspective is in line with recent studies such as those by Gallagher (2015), Kaltenbrunner and Karacimen (forthcoming), Kaltenbrunner and Panceira (2014) and Powell (2013).

17 Some countries of similar relevance, such as the Russian Federation, are not included due to the lack of detailed data in the World Bank's *International Debt Statistics*.

18 The spike in private capital inflows recorded in 2005 is in fact the way the World Bank recorded debt relief.

19 For a discussion about channeling FDI for the good of development, see the joint UNCTAD/ILO volume on industrial policy (Salazar-Xirinachs et al., 2014).

20 See *Financial Times,* "Real estate and China dominate FDI flows", 4 June 2015.

21 UNCTAD, 2015: 18, table I.5.

22 Between 2011 and 2013, net FDI inflows to DTEs consisted of, on average, reinvested earnings (45 per cent) and intra-firm loans (22 per cent); the remaining 33 per cent consisted of equity, including mergers and acquisitions (UNCTAD, *World Investment Report* database).

23 For a recent review, see Thirlwall, 2011.

24 See Patnaik (2007) for an analytical exposé of the limited effectiveness of precautionary holdings of foreign-exchange reserves; and also Torija Zane (2015), with special reference to central banks in Latin America.

25 For formal derivations of the points made here, see Patnaik and Rawal, 2005; and Patnaik, 2006.

26 Herndon et al. (2013) replicate and empirically challenge Reinhart and Rogoff (2010b and 2010c), whose writings have been widely used to support fiscal austerity arguments based on the stylized finding that public debt exceeding 90 per cent of GDP reduces growth. Herndon et al. (2013) conclude that Reinhart's and Rogoff's selective exclusion of data, coding errors and inappropriate weighting of summary statistics underlie the result on public debt and growth. When these errors are corrected, the results show that the growth consequences of public debt vary and the effects are modest.

27 In Latin America, the context of overvalued exchange rates, expanding domestic demand and a more open trade regime, "led to increased imports and a growing current-account deficit, which was financed by foreign investors who were attracted by the promise of higher returns. However, the creative process of technological progress and restructuring remained to be carried out, and the macroeconomic environment of high interest rates, strong exchange rates and volatile capital flows did little to support the new investment required for such a transformation. Thus policy reforms were unsuccessful because the 'creative' element in the 'destruction' process failed to bring about real transformation of the productive structure through higher investment and technological change" (*TDR 2003*: 145–146).

28 These ripple effects are grouped separately from the Asian financial crisis in order to differentiate between the regional contagion of that crisis and how these costs manifested in other emerging market economies.

29 These data and the term "capital flow bonanza" are from Reinhart and Reinhart (2008), who note that, although a better measure would be reserve accumulation less the current account balance, the longer time series and greater consistency of data on the current account make this a satisfactory substitute.

30 This section limits the discussion to Latin America. Many other developing countries were swept up in the same cycle of financial crises, but the Latin American experience is emblematic of the larger economic forces at work.

31 Even Brazil, which had capital controls and did not experience much capital flight, suffered because of the general suspension of lending to Latin America (Díaz-Alejandro, 1984).

32 As a share of GDP, the current account deficits of Thailand and Malaysia that year were -8.1 and

-4.4 per cent respectively (IMF, *World Economic Outlook* database, October 2014).

33 Wade considers the Republic of Korea a different case on the grounds that there it was more the industrial conglomerates that had links with finance through their access to cheap foreign capital, rather than vested interests in property.

34 Taiwan Province of China and Hong Kong (China) successfully fended off speculative attacks, but the Republic of Korea was much more exposed because of short-term debt.

35 By contrast, government spending on goods and services as a share of GDP rose from 19.2 per cent in 1994 to 20.6 per cent in 1998, with the bulk of the rise occurring in 1995 (when it increased to 21 per cent) as a result of a one-time positive shock of inflation-related adjustment of wages and salaries (*UNCTADstat*).

36 Source: World Bank, *World Development Indicators* database.

37 See also Demirgüç-Kunt and Detragiache,1998; Reinhart and Reinhart, 2008; and Weller, 2001.

38 In mathematical terms, the main accounting identity defines GDP as the sum of consumption (C), private investment (I), government expenditure (G) and exports (X) minus imports (M). Simple assumptions allow specifying the tax rate (t) and the savings and import propensities, s and m respectively, as:
$T = t \cdot GDP$; $S = s \cdot GDP$; $M = m \cdot GDP$,
where T stands for total tax revenue and S for private savings. Arrangements of these equations around the accounting identity yield the expression:
$GDP = (G + I + X)/(t + s + m)$, or alternatively:
$GDP = w_t \cdot (G/t) + w_s \cdot (I/s) + w_m \cdot (X/m)$
where w_t, w_s and w_m are the weights of each of the leakages (tax, savings and import propensities, respectively). This equation establishes that growth of GDP depends on the growth of the three variables, G/t, I/s and X/m; defined as fiscal stance, private stance and external sector stance, respectively, amplified by the strength of the respective multipliers, given the mentioned weights, in the macroeconomic context. To avoid complicating the presentation with derivation of the steady state conditions, it is sufficient to note that these stances reflect financial conditions as well, where a larger numerator than the denominator points towards a net borrowing position. Thus, a steady path of sustained growth and financial stability requires that none of these stances grow at a proportionally faster pace than the others for a prolonged period of time.

39 The external account became the leading driver in 40 per cent of these cases, and became significantly more important in another 27 per cent of cases.

40 See Frenkel and Taylor (2006) for a discussion of the varying circumstances and challenges that are associated with managing the exhange rate to support development.

41 Data from the World Bank (2013) indicate that at the end of 2012 the share of non-resident holdings in local DTE debt markets was 26.6 per cent, and that it was as high as 40 per cent in some economies (cited in Akyüz, 2014: 20).

42 See *TDR 2013*, annex to chap. I, where a global model simulation provides empirical illustration of the fact that policies based on improved labour income and supportive fiscal policy yield weaker results, even if still positive, when partner countries take an opposite stance and profit in a typical "free-rider" manner.

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