

# TRADE AND DEVELOPMENT REPORT, 2016

Structural transformation for  
inclusive and sustained growth

## *Chapter V*

### PROFITS, INVESTMENT AND STRUCTURAL CHANGE



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## PROFITS, INVESTMENT AND STRUCTURAL CHANGE

### A. Introduction

Adequate investment finance to priority sectors is essential for achieving structural transformation. It helps enhance a virtuous circle of rapid productivity growth, more and better paid jobs, higher household incomes and expanded markets – both at home and abroad – leading in turn to higher levels of investment, and thus helping to further boost productivity. As discussed in previous chapters of this *Report*, investment in industrial capacity appears to play a catalysing and sustaining role in this process.

All countries seeking to climb the development ladder face the challenge of finding the right mix of macroeconomic and other policies that ensure adequate financing for much-needed investments. Resolving this challenge is crucial, since historical evidence suggests that a steady rise in the minimum level of investment is necessary to launch and sustain efforts aimed at catch-up industrialization (chapter II).

In the corporate sector, a significant proportion of financing for capital formation derives from “internal” resources (i.e. retained profits), notwithstanding the greater weight of banks and other financial institutions in intermediating savings and investments in

recent years. The relationship between profits and investment seems to have been strongest, and thus associated with a dynamic profit-investment nexus, where the manufacturing sector was expanding (Ros, 2000). This was the case for developed Western economies, both during their own industrialization processes as well as during their post-war recoveries, and for East Asia, when it was undergoing rapid industrialization beginning in Japan in the 1950s, followed by the first-tier newly industrializing economies in the 1960s and China from the 1980s. It also applied to more short-lived success stories, such as Brazil in the 1960s and 1970s.

Yet the link between profits and investment is neither spontaneous nor direct. It can be weakened by competing claims on profits by shareholders and

stakeholders. In larger firms – especially public companies – owners and managers (as well as other stakeholders) may pursue different objectives and strategies that influence the use of profits.

The relationship between profits and investment has been weakening since the 1980s, most notably in several developed economies, including the United States, where record profits registered at

Adequate finance is essential for structural transformation; it can support a virtuous circle of rapid growth, more jobs, higher incomes and thus higher investment levels.

the aggregate level have been coexisting with weak investment rates. This has coincided with changes in the way corporations seek to safeguard or generate higher profits – by focusing primarily on cost-cutting, oligopoly rents, outsourcing and delocalization as the main strategies. On some counts, this phenomenon of “profiting without producing” (Lapavitsas, 2013) has given rise to a post-financial-crisis world of “profits without prosperity” (Lazonick, 2013), and has contributed, in part, to deepening concerns about the trend towards “secular stagnation”. Such a situation is thus attributable less to demographic and technological pressures and more to macroeconomic developments, including growing market power, worsening income distribution and insufficient levels of global demand.

The decoupling of profits and investment has also coincided with changes in corporate governance that tie managerial decision-making more closely to shareholder interests at the expense of other stakeholders, arguably weakening the commitment of financial resources to longer investment horizons and biasing investment patterns towards sectors and activities that promise quick returns.

While these developments have been quite pronounced in developed countries, the emergence of similar trends can be observed in developing countries as well, though with regional variations. The share of profits in gross domestic product (GDP) has been rising, while capital accumulation across different regions of the developing world has been slowing down following a period of recovery during most of the 2000s. At the same time, financial activities and financial globalization – whether measured by a larger share of financial services in GDP, more open capital accounts, growing cross-border capital flows, the internationalization of the banking system and/or the rise of shadow banking – have also been on an upward trend in developing countries.

Debt and equity finance (which constitute “external finance” from a firm’s point of view) are other important sources of financing for productive investment, in addition to retained profits (i.e. “internal finance”). Financial globalization was widely expected to help boost productive investment and

growth in developing economies (see chapter II). And it has undoubtedly increased the geographical reach of capital, creating new investment opportunities for firms and wealth owners, as well as providing new sources of funding for public and private investment.

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Productive investment seems to have been affected by a shortening of time horizons as well as by inadequate financing mechanisms.

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However, as discussed in previous *TDRs*, while some areas of the global economy have been inundated with capital, others have continued to suffer from capital scarcity. More worryingly, in countries that received significant capital inflows, those flows proved to be highly unstable, and productive investment did not increase significantly

(*TDR 2014*). Unfavourable macroeconomic conditions, associated with unstable capital flows, appear to have been a major deterrent to private investment, even when corporate profitability was high and thus not in itself a constraint on capital accumulation. Productive investment also seems to have been affected by a shortening of time horizons on the part of both private and public actors, as well as by inadequate financing mechanisms.

The contemporary investment environment thus presents two paradoxes: profit shares have been rising but have not necessarily translated into higher investment rates; and the rapid development of deeper and more sophisticated financial markets has increased firms’ access to domestic and international finance, but has failed to boost real investment.

This chapter discusses possible reasons for these paradoxes. In particular, it explores to what extent, and for what reasons the profit-investment nexus has been weakening, and with what consequences. Section B revisits this nexus and briefly discusses the stylized trajectories of its evolution over time in both developed and developing economies under conditions of increasing macroeconomic and firm-level financialization processes. Section C describes changes in corporate strategies since the early 1980s that have weakened the profit-investment nexus in developed economies. Section D explores the most significant trends in corporate behaviour in large developing economies using firm-level data over the past 20 years. It finds that the profit-investment nexus is weakening in many large developing countries, as in developed countries. Section E suggests three areas – macro, financial and fiscal – in which policy

action may help reinvigorate real investment and promote an economic and institutional environment

conducive to structural transformation in developing countries. Section F concludes.

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## B. The profit-investment nexus revisited

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Developing countries will, in most instances, require substantially higher rates of investment than their current levels if they are to boost manufacturing in order to achieve rapid economic transformation (see chapter III). Indeed, UNCTAD has consistently emphasized that rapid economic transformation requires adequate financing of investment in industrial plants and equipment and in physical infrastructure. Crucially, this requires proactive policies to develop appropriate capacities of the banking system to create credit and provide liquidity, and more generally to foster the establishment of a robust “profit-investment nexus” (*TDR 1997*, chaps. IV and V; *TDR 2008*, chap. IV; UNCTAD, 2012: 10, 46 and 104–106).

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Dynamic interactions between profits and investment arise because profits are simultaneously an incentive, a source and an outcome of investment.

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Essentially, the nexus is the result of “the dynamic interactions between profits and investment which arise because profits are simultaneously an incentive for investment, a source of investment and an outcome of investment” (Akyüz and Gore, 1996: 461). Expectations of strong profits encourage firms to invest, and, if such profits are realized, they increase firms’ capacity to finance future investments out of retained earnings. An essential implication for developing economies is that investment activity is not determined by a given level of pre-existing savings, as the Solow growth theory and its modern-day successors would suggest; indeed, savings may be low simply because investment is low (Hirschman, 1958). Rather, the prospect of expanding demand, and of a consequent increase in profits, is a key driver of investment.

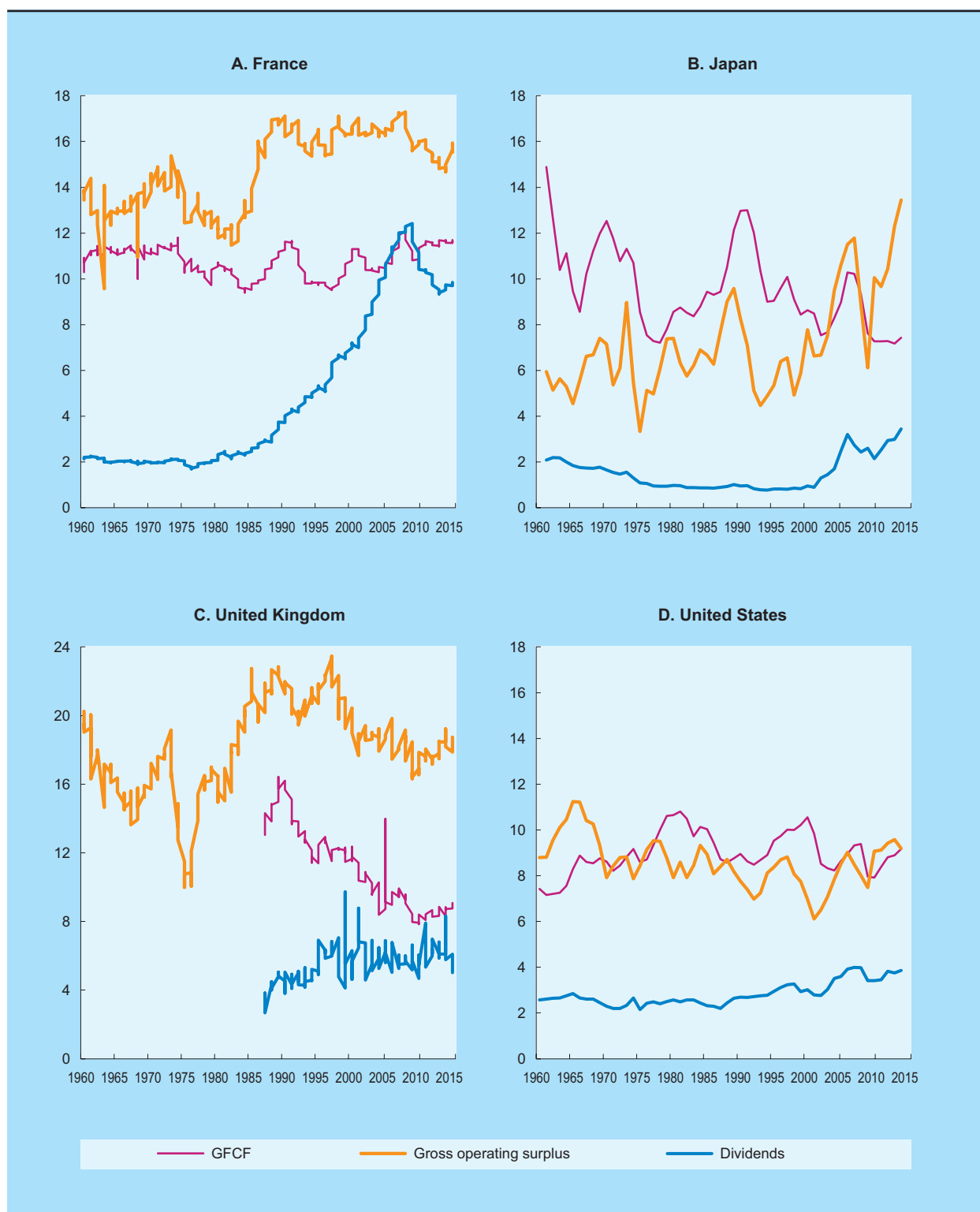
This also applies at the international level: a core tenet of the “savings-gap” theory is that insufficient domestic savings in poorer economies need to be compensated for by accessing “foreign savings” or capital inflows in order to achieve productive capital accumulation. But if it is increased investment activity, induced by expectations of realizing profits in growing markets, that creates and expands firms’ capacity to finance new investments out of retained earnings, the causality works the other way round as well. Thus, in order to build entrepreneurial capacities and finance structural transformation, developing countries have a greater need to access international markets for exports, rather than relying excessively on foreign savings. The latter maybe volatile and may also finance consumption or asset bubbles rather than additional investment in productive capacity.

Importantly, earlier *Trade and Development Reports (TDRs 1996, 1997 and 2008)* made it clear that a dynamic profit-investment nexus as the basis for self-sustaining capital accumulation in later developers cannot be expected to emerge spontaneously; it requires institutional innovation and proactive policy intervention. An indispensable ingredient for the emergence of a thriving entrepreneurial class and for dynamic innovation-driven development is credit and liquidity provision by the banking system, whose primary task should be to channel such ex-ante financing to productive investors (Schumpeter, 1934/2008). However, a modern banking and financial system that provides credit and liquidity is not

Chart 5.1

**PROFITS, INVESTMENTS AND DIVIDEND DISTRIBUTION OF NON-FINANCIAL CORPORATIONS,  
SELECTED COUNTRIES, 1960–2015**

(Per cent of GDP)



**Source:** UNCTAD secretariat calculations, based on national statistics.

**Note:** GFCF = gross fixed capital formation.

Chart 5.2

a sufficient condition in and of itself for a high rate of capital accumulation. In addition, a range of government policies is needed to accelerate the process of capital accumulation and induce private firms to reinvest retained profits in productive sectors and activities. Such policies include designing financing instruments that allow access to temporary rents and help increase profits of dynamic firms over and above what they could achieve without public intervention (see section E). This strategy was first used by policymakers in the United States as they sought to achieve an independent and industrial future following the break with British rule (Cohen and DeLong, 2016), and it was repeated, with local adaptations, by subsequent industrializing economies.

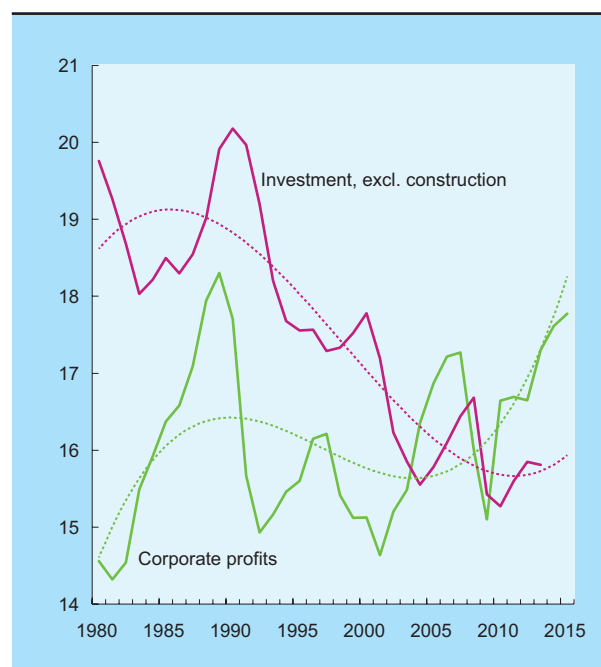
The period of rapid economic growth in developed countries between the early 1950s and the late 1970s also saw profits and investment broadly move in tandem in France, Japan, the United Kingdom and the United States (chart 5.1). Retained earnings from corporate profits represented an important source of savings, which financed capital accumulation that helped the adoption of new technologies and spurred productivity growth. This, in turn, generated higher incomes, which then led to more profits and therefore savings, thereby creating an investment-profit dynamic.

Identifying feasible and appropriate measures to support a profit-investment nexus in developing countries is a major challenge for policymakers in the present-day context of increasing integration of production into global value chains and greater international capital mobility. To meet this challenge, policymakers need to take into account the weakening of the profit-investment nexus due to a number of trends in investment and profit behaviour in developed economies. Since the 1980s, and more markedly since the 2000s, corporate profits have been rising faster than capital expenditures which, apart from cyclical fluctuations (chart 5.1), have remained almost stagnant (chart 5.2). This naturally raises the following questions: why is the corporate sector not reinvesting its profits to expand productive activity, and where are these resources being targeted?

Arguably, after the 2008–2009 global crisis, firms used retained profits to strengthen their balance sheets. In this sense, the slowdown of corporate investment reflects deleveraging efforts. In countries such as Japan, the United Kingdom and the United

### CORPORATE PROFITS AND INVESTMENT (EXCL. CONSTRUCTION), 1980–2015

(Per cent of GDP)



**Source:** UNCTAD secretariat calculations, based on data from Oxford Economics; and OECD, *National Accounts*.

**Note:** Chart shows average values for France, Germany, Japan, the United Kingdom and the United States.

States, the corporate sector as a whole exhibited net saving surpluses that helped improve firms' net financial positions and finance the rest of the economy (Gruber and Kamin, 2015). However, the reduced use of retained earnings to finance real investment cannot be explained only by efforts to repair corporate balance sheets after the crisis. Since the 1980s, there has been an increasing tendency for companies to channel their profits to shareholders either in the form of dividend distribution or share repurchase. Given that dividend distribution remained robust after the 2008–2009 crisis, the slowdown in investment cannot be attributed solely to the need to repair companies' balance sheets.

The profit-investment nexus appears to have weakened in many larger developing countries as well (see section D). However, both the reasons for and the extent of this weakening seem to differ

between developed and developing economies, given their very different productive structures, levels of international competitiveness and their respective degrees of policy and regulatory controls over their integration into the global economy.

Strengthening the profit-investment nexus and its capacity to sustain the capital accumulation needed

for structural transformation is a complex task involving multiple determinants. Those determinants include the global economic environment, institutional, technological and structural change and, as mentioned, the emergence of a supportive domestic banking and financial system, as well as an appropriate industrial policy regime (see chapter II). To better grasp the importance of establishing a functioning profit-investment nexus for successful structural transformation, it is useful to consider the changing dynamics of this nexus over time. In the early stages of structural change, the profit-investment nexus is weak: opportunities to generate profits for reinvestment – outside extractive industry enclaves – remain limited, since poor economies are characterized by small manufacturing sectors, low productivity levels, high production costs and concomitant low levels of industrial and international competitiveness. The institutional, regulatory and policy frameworks required to support a virtuous circle of high profit expectations, the realization of profits in the markets, the expansion of productive capacity, subsequent further increases in market demand and renewed high profit expectations, do not exist at this stage. This initial lack of a *dynamic* relationship between profits and investment is characteristic of a situation in which the share of investment financed out of retained profits (“internal finance”) is high relative to “external finance”, in particular debt financing. In fact, retained profits are typically the main source of investment finance in many poor developing economies (table 5.1).<sup>1</sup> However, rather than a self-sustaining, dynamic profit-investment relationship, this merely reflects firms’ limited access to external sources of finance at this stage. As a result, overall profits remain low, with firms unable to generate by

themselves increases in their rates of profit that can finance a sustained process of capital accumulation. Policy intervention to establish a self-sustaining profit-investment nexus is therefore essential.

Over time, and as the ability to combine internal with external sources for financing private investment projects increases, the profit-investment nexus will strengthen. Concomitant increases in the level of industrial and international competitiveness will, at least in part, reflect a strong empirical relationship between the growth rate of output in the manufacturing sector and manufacturing productivity growth, which in turn will require access to export markets – the so-called profit-investment-export nexus (*TDR 1997* and UNCTAD, 2012).

There is no *a priori* reason to assume that at an advanced stage of industrial competitiveness the profit-investment nexus will weaken. But it is reasonable to assume that any additional strengthening of that nexus is bound to flatten out once high levels of industrial competitiveness are reached: institutional and policy innovations are not likely to grow at a constant or increasing rate forever. Thus, once core institutional and policy capabilities are in place to establish and promote the profit-investment nexus, additional improvements will be more piecemeal.

This said, the growing role of external financing of productive investment as the profit-investment nexus strengthens poses formidable policy challenges of its own. In the early stages of economic development and transformation, the main challenges include increasing firms’ access to long-term bank lending, and developing a domestic banking and financial system capable of channelling credit to productive investment projects. Public intervention to address market failures due to information asymmetries is particularly important. Once a dynamic profit-investment nexus is in place, the challenge is to ensure that large firms’ use of external finance is aligned with society’s wider interests, served by the expansion of productive investments.

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The relationship between profits and investment has weakened since the 1980s, most notably in developed countries.

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A dynamic profit-investment nexus does not emerge spontaneously; it requires institutional innovation and proactive policy intervention.

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Table 5.1

**FIRMS' SOURCES OF INVESTMENT FINANCE AND CONSTRAINTS ON THEIR ACCESS TO EXTERNAL FINANCE, BY SIZE OF FIRM, SELECTED COUNTRY GROUPS, 2008–2015**

	Number of countries	Number of firms	Shares of investment finance in total investments					Proportion of firms identifying access to finance as a major constraint
			Internal	Equity or stock sales	Banks	Supplier credit	Other sources	
<b>Developed countries, OECD members</b>								
All firms	13	5 948	65.5	2.9	18.9	3.6	9.1	11.6
Large firms	13	877	62.9	3.5	20.5	4.7	8.4	9.1
Medium-sized firms	13	1 550	61.6	3.4	21.0	3.9	10.1	12.3
Small firms	13	3 521	67.3	2.7	17.8	3.3	8.9	12.1
<b>Developed countries, non-OECD</b>								
All firms	5	1 710	71.8	5.1	14.2	4.3	4.6	21.2
Large firms	5	201	76.1	3.4	12.9	5.1	2.5	20.8
Medium-sized firms	5	485	69.6	4.7	16.7	5.0	4.0	18.4
Small firms	5	1 024	73.3	5.3	12.7	3.9	4.8	22.2
<b>Transition economies</b>								
All firms	17	9 994	74.1	6.4	12.0	3.9	3.6	17.7
Large firms	17	1 211	72.5	4.2	16.8	4.3	2.2	20.1
Medium-sized firms	17	3 404	76.5	4.6	13.4	2.8	2.7	18.0
Small firms	17	5 379	73.6	7.3	10.8	4.3	4.0	17.0
<b>Africa</b>								
All firms	49	23 228	76.7	3.7	10.0	4.2	5.4	39.9
Large firms	49	2 902	72.4	3.3	15.5	5.0	3.8	28.5
Medium-sized firms	49	6 958	75.0	4.0	11.0	4.9	5.1	36.4
Small firms	49	13 368	79.4	3.6	8.1	3.5	5.4	41.9
<b>Latin American and the Caribbean</b>								
All firms	31	14 433	63.5	4.3	20.2	7.3	4.7	30.4
Large firms	31	3 601	63.0	3.8	23.4	7.0	2.8	20.6
Medium-sized firms	31	5 332	62.3	4.2	20.8	8.4	4.3	29.0
Small firms	31	5 500	64.2	5.0	18.4	6.8	5.6	31.7
<b>East Asia</b>								
All firms	3	3 593	76.4	4.2	12.0	2.5	4.9	15.6
Large firms	3	1 140	82.8	5.0	11.6	0.2	0.4	4.6
Medium-sized firms	3	1 311	74.2	4.2	14.5	1.7	5.4	18.6
Small firms	3	1 142	76.8	4.0	9.2	4.0	6.0	14.0
<b>South-East Asia</b>								
All firms	9	7 270	71.7	4.0	16.3	2.7	5.3	16.1
Large firms	9	2 224	68.7	6.8	16.7	3.5	4.3	12.1
Medium-sized firms	9	2 753	67.1	4.2	19.6	4.3	4.8	20.1
Small firms	9	2 293	73.0	4.0	14.4	2.2	6.4	16.2
<b>South Asia</b>								
All firms	6	13 061	72.1	6.5	16.6	1.2	3.6	23.0
Large firms	6	3 121	69.3	3.6	23.9	1.2	2.0	20.8
Medium-sized firms	6	5 428	62.9	8.1	24.7	1.1	3.2	18.1
Small firms	6	4 512	76.8	4.9	12.8	1.3	4.2	26.0
<b>West Asia</b>								
All firms	6	4 371	73.8	2.9	15.4	3.9	4.0	38.9
Large firms	6	681	78.2	1.4	15.6	2.7	2.1	35.2
Medium-sized firms	6	1 399	72.7	2.4	17.7	3.1	4.1	34.5
Small firms	6	2 291	74.9	3.1	14.5	3.8	3.7	41.3

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

**Note:** Small firms = less than 20 employees; medium-sized firms = 20–99 employees; large firms = more than 99 employees.

The weakening of the profit-investment nexus has been observed primarily in developed economies, where the growing dominance of finance and shareholder power first emerged. Importantly, this may not simply be a product of an emerging post-industrial economy; it reflects, in part, policy choices, including financial deregulation. Clearly, for developed economies and their corporations, financialization is a major explanation. Epstein (2015) provides a generic definition of financialization as “the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies.” More specifically, the remainder of this chapter differentiates between the macroeconomic aspects of financial globalization and the microeconomic process of the financialization of corporate strategies. Financial

globalization refers to the macroeconomic process of the rapid integration of a domestic financial and banking system into international financial markets and the growing size of the financial sector relative to the rest of the economy. Financialization of corporate strategies refers to the fast expanding role of financial actors in corporate decision-making and ownership, as well as to an increase in financial activities of non-financial corporations.

For developing economies, the central question is to what extent both financial globalization and the financialization of corporate strategies have affected their prospects for establishing a functioning profit-investment nexus and ensuring that they use their policy space to promote industrial activities and structural change.

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## C. Corporate strategies: Refocusing and financialization

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Over the past few decades, the world economy has undergone significant transformations. The opening up of new markets through trade and capital account liberalization, the mushrooming of cross-border capital flows and mounting levels of private and public debt, as well as the revolution in information and communication technologies (ICTs) have marked a shift towards finance-driven globalization and financialized investment strategies. Consequently, short-term position-taking and the use of financial instruments for trading have become increasingly important corporate practices diverting firms’ focus from the production and trading of tangible goods with long-term profitability horizons. This is with the largely passive support of, and relative independence from, the money and financial markets (Minsky, 1993; Foroohar, 2016).

At the corporate level, this shift towards financialized investment strategies is often associated with the rise of so-called “shareholder primacy”, referring to the growing power of shareholders in managerial decisions. Despite general recognition of

their effectiveness in raising capital for large investment projects, “open” corporations (i.e. firms whose shares are publicly traded and are not controlled by a small group of investors) were initially considered an obstacle to, rather than a vehicle for, shareholder primacy, due to the separation of ownership from control (Berle and Means, 1932/1968). This began to change in the 1960s with the growing notion that control over corporations by capital markets – in particular the role played by equity markets in facilitating mergers and acquisitions of firms, sometimes through hostile corporate takeovers<sup>2</sup> – would promote shareholder primacy (Manne, 1962) and improve the allocation of capital. Supported by further developments in the economic theory of the firm,<sup>3</sup> maximizing shareholder value gradually became the established objective of corporate governance. This in turn prompted two major developments: market metrics, such as a target for return on equity, became central to corporate investment strategies (Davis, 2009; Ireland, 2009); and shareholders came to be seen as the main risk-bearers (or principals) vis-à-vis the managers (or agents). To align the interests of managers with those

of the principals, managerial performance (and pay) increasingly became tied to the short-term financial performance of “open” corporations (Lazonick and O’Sullivan, 2000). This encouraged a greater focus on short-term horizons of strategic decision-making (Useem, 1999; Stout, 2012), cost management and financial engineering, and invited asset stripping through mergers and acquisitions, buyouts and demergers (Krippner, 2005; Froud et al., 2002).

More recently, the rise of “shareholder capitalism” has been further strengthened by three interrelated developments: the fragmentation of productive processes in global value chains (see also chapter IV), a refocusing of the activities of large conglomerates around their “core business”, and an increasing emphasis of institutional investors and professional asset managers on shareholder value. All these factors have contributed to a change in investment behaviour and a weakening of the profit-investment nexus.

The first of these developments was the result of advances in technology, including improvements in transport and logistics, and the deregulation of trade and investment flows, both of which allowed the fragmentation of production into discrete activities. Large corporations built business networks involving intragroup affiliates across multiple locations and independent external suppliers, often based overseas (OECD et al., 2013). Consequently, the global economy became increasingly structured around global value chains, and more deeply integrated and interdependent (*TDR 2002*; and chapter IV of this *Report*).

The second and closely related trend has been corporate refocusing. Since the 1980s, the historical trend of vertical integration and diversification of large conglomerates has been reversed (Markides, 1992; Milberg, 2008). This refocusing of corporate strategies was a response to changing patterns of competition following the growing globalization of markets for goods and services.

Enlarged markets meant more business opportunities, but also stronger competitive pressures to reduce costs. The growing reliance on outsourcing and subcontracting in productive processes was part of employers’ efforts to cut costs. Reducing labour costs was one of the objectives, but not the only one. Many corporations divested entire lines of business or were broken up following hostile takeovers and leveraged buyouts (Liebeskind and Opler, 1992).<sup>4</sup> Such internal breakups were motivated by the need to enhance managerial efficiency through cost reductions in response to the growing

complexity of intra-firm organization, and by what came to be considered “excessive” diversification (Weston et al., 1990). Corporate restructuring was thus primarily designed to increase company profitability and the market value of a firm (Jensen, 1989).<sup>5</sup>

The third shift in the corporate landscape is the growing influence of institutional investors and professional asset managers in management decisions.<sup>6</sup> Since the 1970s, but even more so in the last 20 years, institutional investors have owned an increasing proportion of public equity shares. The subsequent decline in the participation of individual stockholders has been noticeable in developed countries. In the mid-1960s, individual investors held 84 per cent of all publicly listed stocks in the United States compared with only 40 per cent in 2013. This share was even smaller in Japan, at 18 per cent in 2011. And in the United Kingdom, the proportion of public equity detained by individual investors fell from 54 per cent in the 1960s to only 11 per cent in the 2010s (Çelik and Isaksson, 2014). According to UNCTAD (2016), the predominant shareholders in over half of the top 100 multinational enterprises (MNEs) are financial institutions.

Corporate managers have relied on a range of practices to enhance financial returns to meet the expectations of asset

managers and other shareholders. Among the most common practices has been the growing use of firms’ earnings for dividend distribution and stock

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Since the 1970s, but even more so over the last 20 years, institutional investors have substantially increased their ownership of public equity shares.

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The decoupling of profits and investment has coincided with changes in corporate governance that tie managerial decision-making to shareholder interests at the expense of other stakeholders.

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buybacks.<sup>7</sup> The latter increases stock prices to the benefit of shareholders and top managers. Managers are often offered stock options, for example as part of compensation packages.<sup>8</sup> More aggressive mechanisms to increase returns have become quite common, such as mergers and acquisitions through leveraging, often followed by asset restructuring involving the sale or spin-off of non-core business activities within the corporate portfolio. Thus, strategic “refocusing” and the rise of shareholder power (including changing the way it is exerted) constitute a major shift in management policies from one of “retain and reinvest” to that of “downsize and distribute” (Lazonick, 2013).

Reflecting these changes in corporate governance, the Organisation for Economic Co-operation and Development (OECD) updated its well-known *Principles of Corporate Governance*, first published in 1999, with an emphasis on safeguarding shareholder interests. Subsequent revisions of the OECD Principles in 2004 and 2015 have become a core reference for sound corporate governance and have highlighted areas of major failure. These include criticism of executive remuneration schemes, seen as failing to protect companies from excessive risk-taking (particularly common in a number of financial services companies) and as hurting the longer term interests of stakeholders (Kirkpatrick, 2009). Similarly, the guidelines reflect widespread concerns over the short-termism of some types of hedge funds operating as institutional investors, due to their exceedingly short investment horizons and speculative investment strategies (Çelik and Isaksson, 2014).

The globalization of corporate activity, the refocusing of corporate strategies and greater shareholder power were widely welcomed on the grounds that these would enhance economic efficiency and increase production. It was argued that the fragmentation of the production process into separate activities in different locations would facilitate a stronger focus on comparative advantages and a more efficient division of labour than would have been possible prior to the ICT revolution. Moreover, it was believed that corporate refocusing would improve firms’ results by helping reduce “excessive” diversification. Last but not least, as mentioned above, the growing role

of institutional investors and professional asset managers in corporate decision-making was seen as promoting efficient corporate governance and solving “agency problems” arising from the separation of ownership from control.

A common belief among the supporters of such changes was that capital markets would intermediate efficiently between agents with funding needs and those with funding capacities (Friedman, 1970; Brav et al., 2008; Greenwood and Schor, 2009). Therefore, payouts by companies to their shareholders would not threaten the availability of resources for investment, since any project expected to be profitable would easily find interested investors in the global capital markets. It was argued that financial globalization would help organize

the productive system around global value chains, with financial intermediaries ensuring the smooth reallocation of surpluses from different activities to their most efficient uses. Investment financing would not be compromised; on the contrary, it would be improved by a weakening of the profit-investment nexus at the company level, since external financing would allocate capital even more efficiently.

However, critics of this optimistic view highlight the potentially harmful effects of the financialization of corporate strategies, as it diverts resources away from real investment and innovation, and therefore also adversely affects employment generation. They argue that pressures to generate short-term financial gains in the stock markets and the threat of hostile takeovers when profitability declines, or threatens to decline, are likely to dissuade managers from taking on projects with a longer term profitability horizon. Empirical work establishing a link between the financialization of corporate strategies and adverse impacts on fixed capital formation has drawn both on macroeconomic data (Stockhammer, 2004; van Treeck, 2007) and firm-level data (Tori and Onaran, 2015).<sup>9</sup>

Others have pointed out that the rise of “shareholder primacy” and the concomitant focus on short-termism have been at the expense of investment in R&D (Lazonick and O’Sullivan, 2000), and have been instrumental in the deterioration of income

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Corporations in developed countries have been increasingly using profits to pay dividends and to repurchase shares.

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distribution in developed economies. Increased payout ratios for large corporations, through dividend increases and share buybacks, as well as fast-rising pay for top executives, including through financial performance schemes such as stock options and awards, have directly contributed to the redistribution of wealth to shareholders and corporate management. Perhaps more importantly, MNEs have been major drivers of a race to the bottom in labour market regulation and corporate taxation policies in developed economies over the past few decades. As Lazonick and O'Sullivan (2000) have argued, the maximization of shareholder value, which has become the dominant consideration in corporate governance and decision-making, has undermined labour and welfare rights, eroded employment opportunities and led to a rise in various forms of precarious employment. Moreover, while the growing use of tax havens and complex methods of tax avoidance were justified on the grounds of firms' fiduciary duty to maximize shareholder value (Milberg, 2008; Froud et al., 2002), it has reduced States' financial capacity to provide and maintain adequate infrastructure. From this perspective, shareholder primacy, rather than ensuring

optimal resource allocation, has contributed to the emergence and persistence of growing macroeconomic imbalances, both nationally and globally.

Overall, it seems clear that these changes in corporate strategies are closely related to increases in corporate profitability, achieved through a growing focus on core business, the internationalization of corporate activities, and the growing market power of MNEs in particular. At the macroeconomic level, shareholder primacy, together with wider processes of financial globalization and integration, have likely contributed to worsening income distributions within countries, along with the erosion of tax bases and weakening aggregate demand. In addition, increasing uncertainty in developed economies has undermined their ability to provide a lead in bringing about the political and economic stabilization necessary to facilitate industrial and structural transformation in developing economies. At the same time, recent policy choices in the major developed economies in favour of fiscal austerity and a persistent decline in public investment have also deterred more vigorous corporate investment.

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## D. The corporate investment environment in developing countries

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While there has been growing interest in trends relating to the profit-investment nexus in developed countries, little attention has been paid to those trends in developing countries.<sup>10</sup> To fulfil this gap, this section seeks to provide some idea of the nexus trends in developing countries by combining macroeconomic investment and profit data from national accounts with more detailed information from firms' financial statements.<sup>11</sup>

At the macroeconomic level, trends in investment shares for selected developing economies reveal diverse trajectories of capital accumulation since 1970

(chart 5.3). In line with rising incomes, the share of investment in GDP grew in China and India from the early 1970s, albeit much more rapidly in the former (5.3B). Whereas in China higher invest-

ment supported industrialization and urbanization, in India it was primarily concentrated in the services sector, covering communication services, trade, tourism and information technology for finance, and to some extent also resource extraction.

The East and South-East Asian economies saw a fall in investment shares from the very high levels of 35–40 per cent of GDP registered in the mid-1990s,

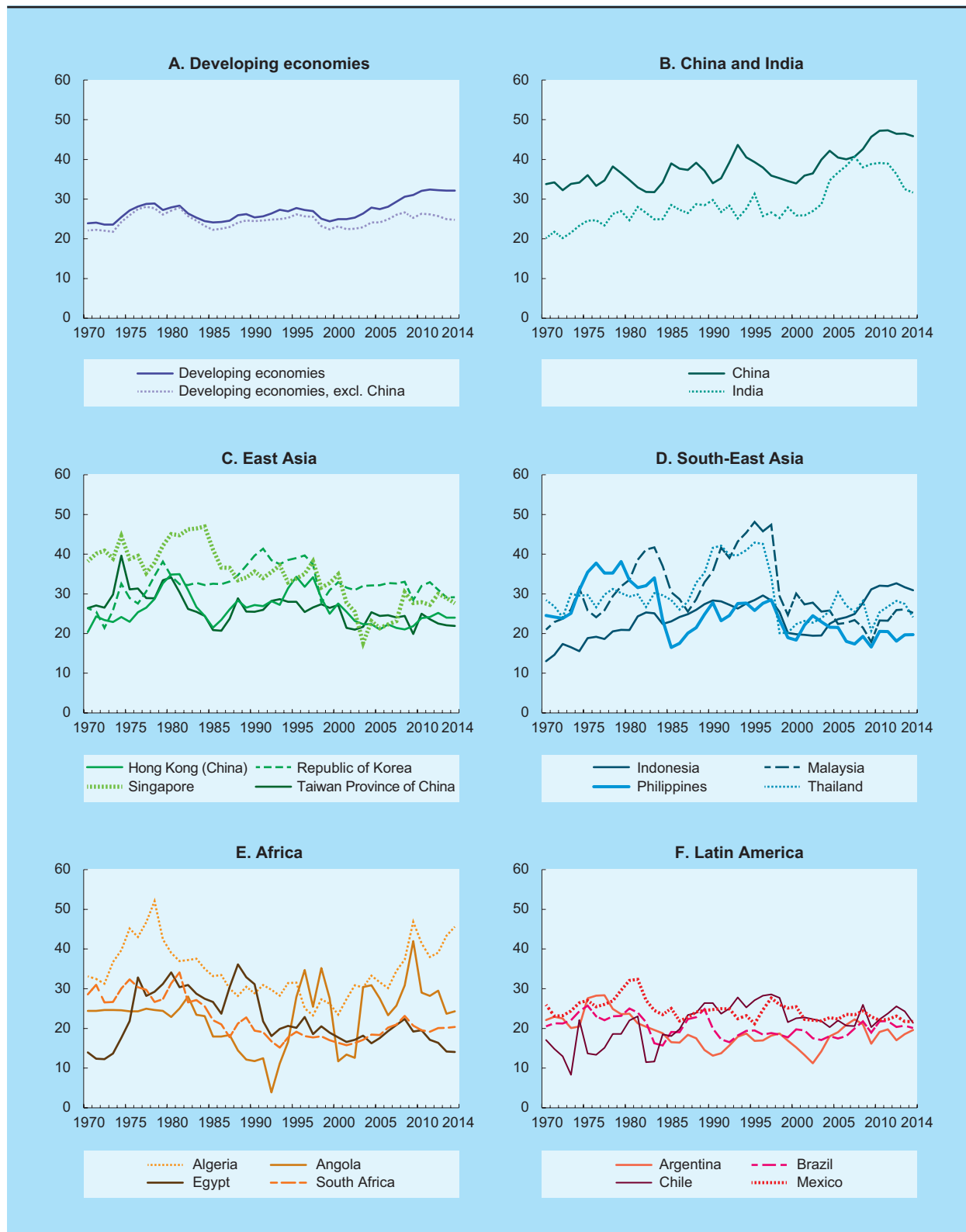
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**Investment trajectories have varied widely in different developing regions, whereas profit shares in national incomes have increased in nearly all regions since the early 1990s.**

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Chart 5.3

**INVESTMENT IN SELECTED ECONOMIES AND COUNTRY GROUPS, 1970–2014**  
(Per cent of GDP)



Source: UNCTAD secretariat calculations, based on UNCTADstat.

just prior to the 1997 East Asian financial crisis (chart 5.3C and D). Those high investment shares reflected, at least in part, high-risk lending and overinvestment, largely in real estate. Following the crisis, investment gradually recovered in most of the countries in these two subregions, stabilizing at 25–30 per cent of GDP. This is above the level of 25 per cent that UNCTAD (*TDR 2003*) considers the minimum required for sustained growth, and it helps explain the solid GDP growth performance of these economies.

Investment shares in large African countries have been highly volatile over the past 40 years (chart 5.3E). In the larger economies of Latin America (chart 5.3F), with the exception of Chile, those shares have been falling moderately. In both regions, this has been mainly the result of an economic environment characterized by large financial and terms-of-trade shocks, frequent macroeconomic crises and policy shifts away from previous industrialization strategies guided by developmental States. In the 2000s, real investment increased in the context of a more favourable environment, although in most countries investment shares did not reach the peaks of the mid-1970s. This upward inflection in investment helped underpin economic growth in many developing countries. In Africa, Latin America and parts of Asia, the growth in real investment was driven by the commodity boom of the 2000s. In many commodity exporters, a positive impact on government revenues enabled expansionary policy stances, including increased public investment in social and physical infrastructure projects. In only a few countries, did this process stimulate private investment to support the expansion of capacities in natural-resource-based industries, as well as in processing and other industries.

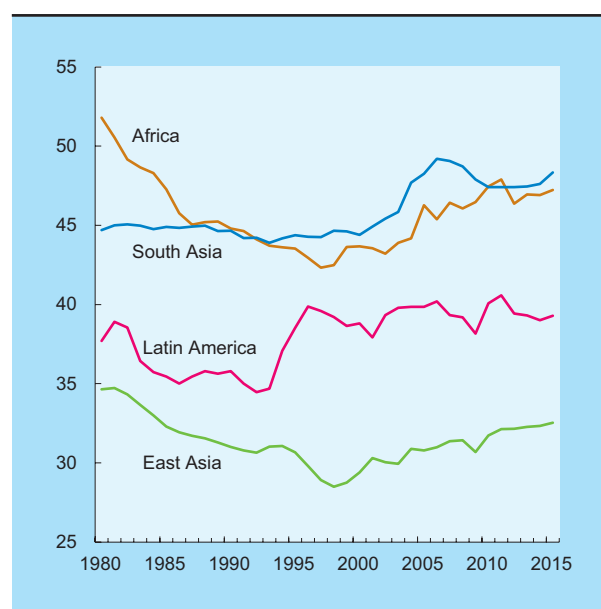
Meanwhile, the share of profits in national income increased in virtually all developing regions between 1990 and 2015 (chart 5.4). This overall trend was only partially reversed in the 2000s in Africa and, more strongly, in South America, as a result of improved labour market conditions and distributional policies that increased the wage share (*TDRs 2012* and *2014*).

These varying investment trajectories, on the one hand, and a general trend of rising profit shares, on the other, would suggest that the relationship between profits and investment may be weakening in many developing countries. In addition, rising trends in debt financing at the corporate level since

Chart 5.4

### GROSS OPERATING SURPLUS, BY REGION/SUBREGION, 1980–2015

(Per cent of GDP)



**Source:** UNCTAD secretariat calculations, based on UNSD, *National Accounts*; ILO estimates from *Global Wage Reports*; OECD, *National Accounts*; European Commission, *AMECO* database; Economic Commission for Africa; and Economic Commission for Latin America and the Caribbean.

2010 have failed to translate into investment in high productivity sectors, adding to macroeconomic vulnerabilities (see subsection D.3).

#### 1. Challenging macroeconomic conditions for private investment

In almost all developing countries, including those that witnessed stagnating or declining investment rates, financial intermediation has gained prominence, particularly in the past 15 years or so. This can be evidenced by different financial market measures, such as domestic credit provided by the financial sector, the size of assets of insurance companies and mutual funds, and stock market capitalization (table 5.2). While some growth in the share of financial activities in GDP can be expected as an economy develops, this phenomenon has accelerated

Table 5.2

**SIZE OF THE FINANCIAL SYSTEM, SELECTED INDICATORS AND ECONOMIES**

(Per cent of GDP)

	Domestic credit by the financial sector		Stock market capitalization		Stocks traded – total value		Insurance companies’ assets		Mutual funds’ assets	
	(Average values)									
	1996– 2000	2011– 2014	1989– 1992	2011– 2014	1992– 1995	2011– 2014	2000	2013	2000	2013
<b>Africa</b>										
Angola	5.0	15.6	..	..	..	..	6.5	1.6	..	..
Egypt	82.7	79.7	5.0	21.7	..	6.6	4.1	2.8	1.1	4.6
Morocco	70.5	111.4	3.6	52.7	3.5	2.9	16.1	18.7	9.0	26.4
Nigeria	14.6	21.7	4.4	12.1	0.2	1.1	1.2	1.7	..	..
South Africa	140.8	180.0	108.4	235.5	7.8	66.8	38.5	62.1	12.7	40.7
<b>Developing Asia</b>										
China	108.6	155.0	2.4	47.2	10.6	86.3	7.4	12.2	12.4	5.1
Hong Kong, China	145.5	216.8	118.7	1 055.7	85.9	486.6	11.6	53.8	181.4	470.6
India	59.3	41.1	12.5	65.3	1.7	33.3	12.1	17.9	2.9	5.6
Indonesia	46.6	76.2	4.5	44.0	6.5	10.7	2.2	3.7	..	..
Malaysia	151.3	133.3	105.3	142.9	34.1	42.3	17.4	21.2	12.1	34.0
Philippines	65.4	52.6	20.4	84.3	16.4	14.4	5.6	7.8	0.1	1.7
Republic of Korea	60.5	156.8	34.4	90.0	45.4	120.8	30.2	58.2	19.7	21.9
Singapore	75.4	105.1	94.3	243.0	91.8	86.8	27.9	43.7	..	..
Thailand	156.6	158.1	31.5	90.3	55.4	69.5	8.4	20.2	1.2	3.7
Viet Nam	25.0	109.3	..	21.4	..	7.8	3.4	3.8	..	..
<b>Latin America</b>										
Argentina	32.2	30.6	5.4	8.3	21.0	0.4	2.6	3.1	2.6	2.3
Brazil	64.1	100.5	3.6	43.3	9.6	30.5	3.4	10.4	25.2	49.7
Chile	65.5	114.6	44.6	103.0	8.8	15.8	15.7	20.2	6.1	13.8
Colombia	38.8	68.9	5.3	55.8	2.0	6.6	2.6	6.0	0.2	0.1
Mexico	31.7	47.9	17.4	39.5	11.3	10.4	2.8	5.8	3.4	10.1
Peru	23.1	21.1	2.6	45.1	6.4	2.2	2.1	5.2	2.6	3.0
Venezuela, Bol. Rep. of	17.6	48.0	11.0	..	1.6	..	1.6	3.1	..	..
<b>Other</b>										
Russian Federation	32.1	45.9	..	35.0	..	10.0	2.7	1.7	0.1	0.2
Turkey	34.2	79.6	6.6	29.2	22.4	45.9	1.6	3.6	1.2	1.7
<b>Developed countries</b>										
France	98.4	146.4	27.4	69.3	12.0	40.3	70.1	105.3	54.4	56.0
Germany	133.7	149.2	18.2	42.5	23.9	33.9	50.5	62.7	40.7	52.8
Japan	293.0	356.6	103.1	75.6	20.0	114.5	42.7	87.8	9.1	15.8
United Kingdom	116.7	186.0	58.7	111.0	37.3	70.3	99.5	94.2	24.1	46.9
United States	186.5	238.6	83.5	127.7	51.5	211.0	38.8	43.6	61.3	91.1

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

with the increasing integration of countries into global financial markets. Such integration has led to greater complexity in financial transactions and instruments, and has enabled the participation of foreign players in different domestic markets, including

stock exchanges and corporate bond markets (*TDR 2015*; Akyüz, 2015).

In many developing countries, declining and volatile investment rates have been associated with



an environment characterized by macroeconomic instability and uncertainty, reflected in growing financial and trade imbalances. For many years UNCTAD has emphasized that volatile international capital flows in the wake of external financial liberalization have been a major source of this instability. Previous *TDRs* have shown that financial flows can be quite large, and are often driven by policy decisions in developed source economies rather than by demand factors in recipient developing countries. These procyclical flows tend to generate financial asset bubbles and currency appreciations, mispricing investments and therefore sending the wrong signals for capital allocation. At the corporate level, their greater use makes companies more vulnerable to the vicissitudes of international finance. The often sudden reversal of such flows can cause massive exchange rate depreciations and inflationary pressures in the recipient countries, resulting in procyclical monetary and fiscal tightening (*TDR 2014*: 123–124). Consequent negative impacts on aggregate demand, coupled with growing uncertainty, further discourage domestic investment.

A prime example of a surge in financial inflows driven by policymaking in developed economies is that associated with quantitative easing (QE) in recent years. Since late 2008, major central banks (the United States Federal Reserve, the Bank of England, the Bank of Japan and later the European Central Bank) embarked on unconventional monetary policy programmes to stimulate investment, mainly by encouraging banks and other financial institutions to increase their lending. Central banks not only targeted overnight interest rates to bring them to near-zero levels, but they also engaged in large-scale asset purchases to lower long-term yields and improve financial conditions for borrowers.

Several rounds of such asset purchase programmes over the past seven years increased central bank balance sheets to multiples of their original size and resulted in a flood of cheap credit inundating international financial markets.

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Procyclical capital flows are not reliable sources of long-term development financing.

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Weakened global demand as a result of low levels of corporate investment and worsening income distribution harm developing-country exports and prospects for investment.

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A considerable proportion of these cheap funds ended up as liabilities on the balance sheets of corporations in emerging market economies, either as banking debt or as corporate bond debt (Lo Duca et al., 2014). McCauley et al. (2015) estimate that between 2009 and 2014 overseas credit provided through bank loans and bonds amounted to \$9.8 trillion. Around \$7 trillion are thought to have fuelled the expansion of dollar credits in emerging market economies (Wheatley and Kynge, 2015; Palma, 2015). QE cash reached corporate balance sheets in those economies through a number of channels. First, asset purchases by central banks, by driving down yields on financial assets in their countries, prompted asset managers and their clients to look for higher yield investment opportunities overseas, such as corporate bond offerings in the emerging market economies.

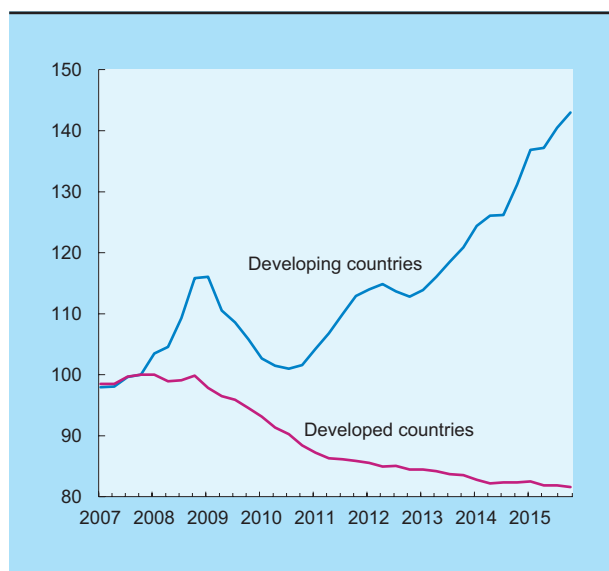
Second, central banks also bought government bonds and asset-backed securities from commercial banks, and the latter went on to lend to other financial institutions, including hedge funds with high-risk investment strategies aimed at leveraging the cash (borrowing additional funds on the basis of the cash obtained) to exploit interest rate differentials or arbitrage in the currency markets (so-called “carry trade”). This, in turn, increased pressures on nominal exchange rates in emerging economies and pushed their central banks to absorb the surge of financial inflows by accumulating foreign exchange reserves. As only part of the foreign exchange purchases could be “sterilized” at reasonable costs, interventions by the central banks could not entirely prevent liquidity from growing rapidly in domestic markets and from fueling domestic asset bubbles. Finally, QE cash also found its way to emerging economies through FDI of the less productive kind, in particular in the form of intra-company loans. These loans accounted for about 40 per cent of FDI in countries such as Brazil and China in 2014 (Chui et al., 2016; Wheatley and Kynge, 2015).

It is difficult to gauge how much of the original and leveraged QE funds were used for productive as

Chart 5.5

**DEBT SERVICE-TO-INCOME RATIO OF THE PRIVATE NON-FINANCIAL SECTOR OF DEVELOPING AND DEVELOPED COUNTRIES, 2007–2015**

(Index numbers, 2007 Q4 = 100)



**Source:** UNCTAD secretariat calculations, based on Bank for International Settlements, Debt service ratio statistics.

**Note:** Chart shows average values for France, Germany, Japan, the United Kingdom and the United States (developed countries) and for Brazil, China, India, Indonesia, Mexico, Malaysia, the Russian Federation, South Africa, Thailand and Turkey (developing countries).

opposed to speculative purposes. Given the flood of cash and cheap credit from developed economies, emerging market corporations adopted a range of investment strategies. Some profited from speculative activities, such as carry trade (Caballero et al., 2015), while others invested in productive projects, and many hedged against growing risk by acquiring overseas subsidiaries and financial vehicles to access foreign currency and financial assets. However, once the Federal Reserve ended its asset purchase programmes in 2014, emerging market corporations ended up with substantial excess capacities and rising debt servicing costs (see chart 5.5 and subsection D.3 below).

Over and above wider macroeconomic instability and volatile capital flows, real capital accumulation in many developing economies may also be hampered by the financialization of corporate strategies in developed economies, essentially through three indirect routes. First, weakened global demand as

a result of relatively low levels of corporate investment and worsening income distribution can harm developing-country exports and therefore the profitability of investments. Second, MNEs and their subsidiaries may not reinvest their profits, or at least a large proportion of those profits, in their host country, choosing instead to reward foreign shareholders in a third economy. While this may be justifiable from the point of view of profit and investment strategies at the corporate level, profit repatriation is likely to have a negative impact on national development strategies aimed at promoting the expansion and diversification of productive sectors in the host country as well as on that country's balance of payments (Akyüz, 2015).

Third, private investment may slow down if there are changes in domestic development strategies involving a withdrawal of proactive strategic guidance and a reduction in public investment. Private investment tends to benefit from sectoral policies that provide an indication of government priorities and facilitate the development of new activities. These include procurement policies that support and/or protect the creation of backward and forward linkages, and financial policies implemented through public and development banks or other sources of long-term finance (see chapter VI). Public investment is an important component of aggregate demand, and therefore directly affects the conditions under which the private sector operates and generates returns. It also tends to "crowd in" private investment, particularly when capital constraints prevail and existing resources are not fully utilized. Moreover, long-term public investment planning as part of a country's development strategy provides an indication of areas in which new investment opportunities for the private sector may arise in the future.

Data from the OECD *Sectoral Transactions and Balance Sheets* show that public investment as a share of GDP declined between 1980 and 2012 for developing countries as a whole, although a recovery can be observed in most developing regions and in the transition economies after 2005 (*TDR 2011*, chap. II). The overall decline, which was mostly due to growing fiscal constraints in these countries, discouraged private investment on both the demand and supply sides through the mechanisms described above. Confronted with competing claims on public resources, many governments faced strong obstacles to increasing revenues through tax reforms or other means. In Africa, Latin America and parts of Asia,

the debt crises that started in the early 1980s, and the fiscal adjustments that followed, reduced public revenues and investment. In particular, governments that were under pressure from international institutions to adopt fiscal austerity measures and from financial markets for debt repayments reacted by delaying, above all, public investment expenditures. These trends were partially reversed in the early 2000s when economic recovery, higher fiscal revenues and larger policy space enabled a significant recovery of public investment in many developing countries.

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The accumulation of financial assets by large firms in developing countries suggests that investment is not necessarily constrained by a paucity of resources, but rather, by weak prospects for profitable real investment.

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On the revenue side, there has been disappointing growth of tax revenues in many countries. Section E below suggests that tax erosion due to tax avoidance and evasion – both of which are a reflection of the financialization of corporate strategies – is one reason for such a poor performance.

## 2. *Microeconomic trends: Incipient corporate financialization in developing countries?*

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Balance sheet data from non-financial firms listed on the stock exchanges of large developing economies show that the investment-profit ratio in such firms fell over the period 1995–2014 (table 5.3). There are some indications that the increasing financialization of corporate strategies in developing countries along with the growing role of financial intermediation in the productive process may have contributed to this decline.

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The rise of corporate indebtedness in emerging market economies since the 2000s has been the result of large surges in liquidity in international markets rather than improved profitability.

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First of all, the total amount of dividend distribution in the subgroup of firms that regularly distribute dividends (i.e. at least once every two years) has risen, although not in all the countries considered. Dividend payouts increased despite broad stability of profitability as measured by the return on equity. It should be emphasized that this subgroup

is relatively small, covering only 23 per cent of the companies in the firm-level database. In developing countries, pressures to create shareholder value are probably still weak, as their ownership structure

differs considerably from that of their counterparts in developed countries (such as the United Kingdom and the United States). In many developing countries, large private shareholders are often wealthy families, and ownership concentration is generally higher than in developed countries (Claessens and Yurtoglu, 2013). Moreover, listed companies are often part of larger business groups and

conglomerates. In these ownership configurations, management practices are less likely to be dominated by the interests of institutional investors or by executives guided by compensation schemes linked to the share value of the firm.

Second, balance sheet data show that firms are accumulating financial assets, in some cases even faster than corporate debt (table 5.3). This indicates that investment by large companies is not necessarily constrained by the availability of resources, but arguably by a lack of aggregate demand and appropriate incentives to engage in long-term (risky) projects in the real sectors. One relevant aspect is that corporations with access to international markets have greater portfolio investment choices. With liberalization, firms can seek financial returns by exploiting interest rate differentials of foreign and domestic markets. The result is that in times when ample

liquidity is available, firms often borrow abroad, not necessarily to invest in real assets but sometimes to engage in financial speculation.<sup>12</sup> This is observed in a recent study by Caballero et al. (2015), who found that non-financial firms in 18 emerging market economies were largely involved in carry trade activities over the period 2000–2014.<sup>13</sup> Bruno and Shin (2015) also found evidence of carry trade

activities being undertaken by non-financial firms in 47 emerging market economies over a similar period. Companies conduct carry trades on the premise that

Table 5.3

**NON-FINANCIAL CORPORATIONS: INVESTMENT AND  
SELECTED FINANCIAL INDICATORS, 1995–2014**

*(Average value for the period, per cent)*

	<i>Investment-to-profits (Aggregate ratios)</i>			<i>Investment-to-capital stock (Median values)</i>		
	1995–2002	2003–2008	2009–2014	1995–2002	2003–2008	2009–2014
Argentina	121.2	91.9	104.9	11.9	9.2	17.5
Brazil	178.2	104.3	79.8	14.1	19.1	18.0
Chile	107.2	109.5	92.7	11.3	9.6	9.1
China	131.1	164.9	105.7	14.2	16.3	16.4
India	122.0	127.5	114.3	20.7	25.7	19.4
Indonesia	109.8	89.4	81.0	16.2	10.7	15.6
Malaysia	88.8	72.3	55.3	11.2	7.8	8.2
Mexico	98.2	92.4	89.2	10.3	10.5	11.4
Republic of Korea	287.8	103.6	106.8	14.3	11.2	10.6
Russian Federation	217.7	134.0	83.2	26.8	10.4	10.6
South Africa	83.3	73.4	65.8	23.5	29.9	19.6
Thailand	84.6	71.5	58.9	10.5	13.0	13.3
Turkey	138.9	73.1	69.1	54.1	13.3	14.0

	<i>Dividends-to-profits (Median values)<sup>a</sup></i>			<i>Return on equity (Median values)</i>		
	1995–2002	2003–2008	2009–2014	1995–2002	2003–2008	2009–2014
Argentina	40.1	19.1	45.8	4.6	6.8	10.1
Brazil	49.2	48.7	45.8	4.6	11.9	9.6
Chile	52.8	59.2	51.4	8.8	8.5	8.3
China	32.4	33.3	40.1	6.5	6.8	8.2
India	28.9	28.7	24.3	14.7	18.5	11.0
Indonesia	25.9	31.4	33.0	6.1	6.7	10.4
Malaysia	23.8	23.8	19.7	7.1	6.6	6.8
Mexico	28.6	36.8	35.4	10.4	10.9	9.1
Republic of Korea	22.2	28.2	26.8	4.3	7.1	5.9
Russian Federation	9.0	26.9	94.0	6.9	5.8	6.8
South Africa	33.8	41.4	44.2	14.2	20.2	11.9
Thailand	38.7	53.6	54.5	4.8	11.6	10.8
Turkey	45.9	36.0	54.7	20.1	7.8	6.0

	<i>Financial assets-to-total assets (Aggregate ratios)</i>			<i>Financial assets-to-debt (Aggregate ratios)</i>		
	1995–2002	2003–2008	2009–2014	1995–2002	2003–2008	2009–2014
Argentina	3.9	7.1	8.6	11.7	26.2	37.9
Brazil	7.1	11.1	11.4	27.9	37.6	35.8
Chile	4.0	5.9	6.5	12.0	19.0	22.7
China	12.9	11.6	12.2	41.9	41.8	38.9
India	4.6	8.7	10.5	13.5	31.0	30.1
Indonesia	10.7	11.1	12.3	21.1	29.1	38.9
Malaysia	6.9	10.9	11.2	15.3	36.6	37.7
Mexico	10.9	13.0	15.0	32.4	42.6	51.6
Republic of Korea	7.9	9.4	10.3	29.6	34.0	33.2
Russian Federation	9.5	12.6	21.0	26.8	45.6	116.0
South Africa	10.4	10.0	9.5	65.3	47.6	42.2
Thailand	7.0	9.0	9.7	13.1	24.6	29.3
Turkey	18.6	13.3	14.6	73.5	53.2	46.5

**Source:** UNCTAD secretariat calculations, based on Thomson Reuters, *Worldscope* database.

**Note:** Capital stock = property, plant and equipment; investment = capital expenditures (additions to fixed assets); profits = net income before extraordinary items/preferred dividends.

**a** Refers only to the subgroup of firms that distributed annual dividends at least 10 times between 1995 and 2014.

Table 5.4

**NON-FINANCIAL CORPORATIONS: DEBT INDICATORS AND LEVERAGE RATIOS, 1995–2014***(Aggregate ratio, average value for the period, per cent)*

	<i>Debt-to-total sales</i>				<i>Debt-to-fixed assets</i>			
	<i>1995– 2002</i>	<i>2003– 2009</i>	<i>2010– 2014</i>	<i>2014</i>	<i>1995– 2002</i>	<i>2003– 2009</i>	<i>2010– 2014</i>	<i>2014</i>
Argentina	71.8	46.2	27.7	28.8	48.5	43.8	41.5	41.0
Brazil	53.5	47.4	59.1	66.8	45.3	67.0	76.5	82.5
Chile	95.0	54.2	57.4	61.4	52.1	53.6	71.8	73.5
China	64.6	37.2	39.8	44.6	59.0	53.7	75.4	81.1
India	46.4	34.9	48.6	51.3	71.4	67.0	87.2	94.5
Indonesia	111.2	50.5	40.8	44.8	105.6	76.7	73.7	78.6
Malaysia	81.6	59.2	54.8	60.5	77.3	69.2	69.5	71.9
Mexico	47.0	39.9	46.5	55.7	45.8	56.9	78.4	86.5
Republic of Korea	50.5	30.8	30.8	32.1	104.2	71.5	78.3	76.8
Russian Federation	111.0	77.7	58.6	53.6	4.0	30.0	17.2	12.4
South Africa	14.8	20.7	25.4	29.3	42.0	46.0	48.1	52.9
Thailand	103.9	38.2	32.5	35.3	119.1	75.5	78.1	83.9
Turkey	22.9	27.7	36.6	33.1	80.9	83.4	106.6	86.9

	<i>Debt-to-equity</i>				<i>Interest expenses-to-total sales</i>			
	<i>1995– 2002</i>	<i>2003– 2009</i>	<i>2010– 2014</i>	<i>2014</i>	<i>1995– 2002</i>	<i>2003– 2009</i>	<i>2010– 2014</i>	<i>2014</i>
Argentina	66.1	54.0	57.5	64.6	7.8	4.2	3.3	4.7
Brazil	57.5	74.6	75.5	96.9	9.3	5.8	4.2	4.5
Chile	96.7	75.9	87.2	86.6	7.2	3.9	3.1	4.1
China	66.2	66.9	92.9	98.5	4.3	1.7	1.8	2.5
India	83.6	72.5	97.9	109.9	4.6	2.4	3.1	3.5
Indonesia	235.5	107.9	75.4	81.1	11.8	3.3	2.9	3.1
Malaysia	89.3	71.6	62.0	63.2	5.1	3.2	2.6	2.6
Mexico	56.5	68.3	80.7	97.7	6.5	3.5	3.1	3.3
Republic of Korea	219.8	92.7	76.7	71.9	4.7	1.5	1.3	1.2
Russian Federation	150.6	95.4	53.5	44.9	5.1	2.8	2.0	1.8
South Africa	35.1	45.0	47.1	49.8	1.8	2.1	2.1	2.3
Thailand	222.5	85.4	75.8	76.0	8.2	1.9	1.4	1.5
Turkey	72.4	64.1	79.8	68.2	6.0	2.1	1.8	2.0

**Source:** UNCTAD secretariat calculations, based on Thomson Reuters, *Worldscope* database.

changes in the financial environment will occur gradually, and that the exchange rate will be more stable than interest rate differentials. However, this strategy can become a significant source of risk for such companies if there are abrupt changes in the exchange rate.

Third, a major feature of the changing corporate environment in developing countries is the notable increase in non-financial corporate debt since 2010,

both in absolute terms and as measured by the ratio of debt to sales and to operating income (table 5.4). According to IMF estimates, the corporate debt of non-financial corporations in major emerging economies increased from about \$4 trillion in 2004 to \$11 trillion in 2010, and to well over \$18 trillion in 2014 (IMF, 2015). For non-financial corporations in the 13 developing countries analysed in this chapter, the total increase in the dollar value of their debt amounted to over 40 per cent between 2010 and 2014.

**Box 5.1****CHINESE NON-FINANCIAL CORPORATE DEBT ON THE RISE**

In response to the 2008–2009 financial crisis, China launched a stimulus programme that involved a huge increase in debt-fuelled investment to offset the weakening of external demand. Chinese firms as well as local government entities borrowed from both banks and non-bank institutions, including the shadow banking system (see *TDR 2015*). Some larger firms also tapped external sources – often via subsidiaries in offshore financial centres – taking advantage of low global interest rates (Avdjiev et al., 2014). Despite the rise in that source of funding, China’s external debt remains very small (about 10 per cent of GDP).

The increase in China’s corporate debt has attracted much attention. That debt increased by over 30 percentage points since 2009 to reach about 170 per cent of GDP in 2015. China’s total debt, including government and household debt, was about 250 per cent of GDP in 2015 (Yao et al., 2016).<sup>a</sup> At around \$17 trillion, China’s total non-financial corporate debt as a percentage of GDP is currently one of the highest in the world. State-owned enterprises (SOEs) are the biggest borrowers, with claims amounting to 99 per cent of GDP. The real estate and construction sector, and to a lesser extent the mining and utilities sectors, account for most of the increase in the debt (IMF, 2015).

Such an upsurge in borrowing following the global financial crisis allowed Chinese companies to maintain their investments, despite the fall in corporate profits and the consequent fewer internal resources for finance. As a result, the corporate sector as a whole has become more leveraged. Chinese firms’ leverage – measured by the ratio of total liabilities to total equity – is not the highest, on average, when compared with that of firms in other developing countries (table 5.4); indeed, the median leverage ratio has even been decreasing. However, leverage has significantly increased at the tail end of the distribution of firms: the median value of the debt-to-equity ratio for the top 20 firms (as measured by market capitalization) grew by 15 percentage points, to 52 per cent between 2007 and 2014, whereas for all firms the median ratio fell below 40 per cent. Among firms, the increase in corporate leverage is largely concentrated in SOEs, and in the real estate sector more broadly (Chivakul and Lam, 2015).

Rising debt and leverage could pose risks to China’s rapid economic growth and financial stability. There is a general decline of profitability, as shown, among other indicators, by the increase in the ratio of interest expenses to total sales (table 5.3). SOEs’ aggregate profits as a percentage of GDP fell from 6.5 per cent in 2007 to 3.4 per cent in 2015 (Yao et al., 2016).

Firms’ non-performing debt has been rising recently, and many payment incidents involving SOEs’ bonds were reported in the first semester of 2016. While corporate bond yields in China are still well below historical averages, spreads widened in the first half of 2016. Among lenders, the most heavily exposed to

The ratio of corporate debt to GDP also increased in many developing and emerging economies, in particular after the global financial crisis. In Brazil, India and Mexico, this ratio has been growing steadily over the past 20 years, whereas in the other major developing economies (e.g. Indonesia, Republic of Korea, and Thailand) the recent increase in their debt burden followed a period of decline. The debt dynamics of Chinese corporations, particularly the State-owned enterprises, have recently become a source of concern (box 5.1). Companies in many of

these countries have been relying more on debt than on equity as a funding source (table 5.4).

Non-financial corporations in most of these economies have also increasingly relied on bond financing in international financial markets, and on cross-border bank lending. This shift has taken place under highly favourable financing conditions, including the fast expansion of liquidity driven by the QE programmes discussed in subsection D.1. A growing concern is that the rise of corporate indebtedness,

**Box 5.1 (concluded)**

corporate debt stress are the domestic banks (which hold 55 per cent of total non-financial debt), followed by creditors through shadow banking channels (23 per cent) and corporate bondholders (8 per cent).

Since most of Chinese debt is internal, it is unlikely that debt stress in China would directly impact international markets. Moreover, even though China's trade surplus has been shrinking, it still has a large current account surplus, making it a net creditor to the rest of the world. Therefore, the probability of a fully-fledged external crisis, including a currency crisis, is very low. However, a debt crisis could have adverse effects on China's income growth, and, given the size of the Chinese economy, on the global economy. Should corporate debt and local government debt turn into significant amounts of non-performing loans, the situation could have serious repercussions on international financial markets. At the domestic level, debt payment incidents will eventually have an adverse impact on banks' balance sheets and place some financial institutions in precarious positions. Even if the authorities were to rescue banks in difficulty and prevent a financial crash, debt restructuring and asset write-offs would jeopardize the country's economic growth.

Chinese officials have expressed concern that such excessive borrowing could threaten the stability of China's financial system. The authorities are encouraging bond-to-equity swaps, whereby banks would write off struggling companies' debts in return for taking equity stakes in them, and more generally they are trying to achieve crisis-free debt restructuring through a gradual approach. They seem willing not only to shut down companies in industries struggling with overcapacity, but also to provide support to some SOEs through capital injections.

The current fragilities call for a cautious approach when undertaking financial deregulation policies. The financial sector in China remains a relatively closed system and is supported by captive savings from the private sector, in which government-influenced financial institutions lend to government-backed firms. There is a risk that further opening up of the capital account would give Chinese savers more channels to diversify their portfolios by investing overseas. Another risk is that domestic capital markets and corporate liberalization would scale back the implicit State guarantees that provide backing for financial institutions and firms (Yao et al., 2016). It seems that the Chinese authorities are undertaking a careful sequencing, giving priority to defusing the risk of a debt crisis before introducing further financial deregulation. Indeed, deregulation could be destabilizing in the near term making a potential restructuring of part of the corporate debt more difficult to manage.

<sup>a</sup> In a speech in June 2016, a top official from the IMF cited IMF estimates that suggested China's total debt was lower, at around 225 per cent of GDP (see: <https://www.imf.org/external/np/speeches/2016/061016.htm>).

driven primarily by the greater availability of liquidity in international markets rather than by firms' own profitability, has been reflected in the recent rise in the ratio of interest expenditures to total sales of firms (though the Republic of Korea and Malaysia are exceptions, as shown in table 5.4). This poses significant potential risks to these firms, as it has made them more vulnerable to interest rate changes and external shocks. In addition, greater borrowing in foreign currency is also creating currency mismatches for firms engaged in non-tradable activities, thus threatening

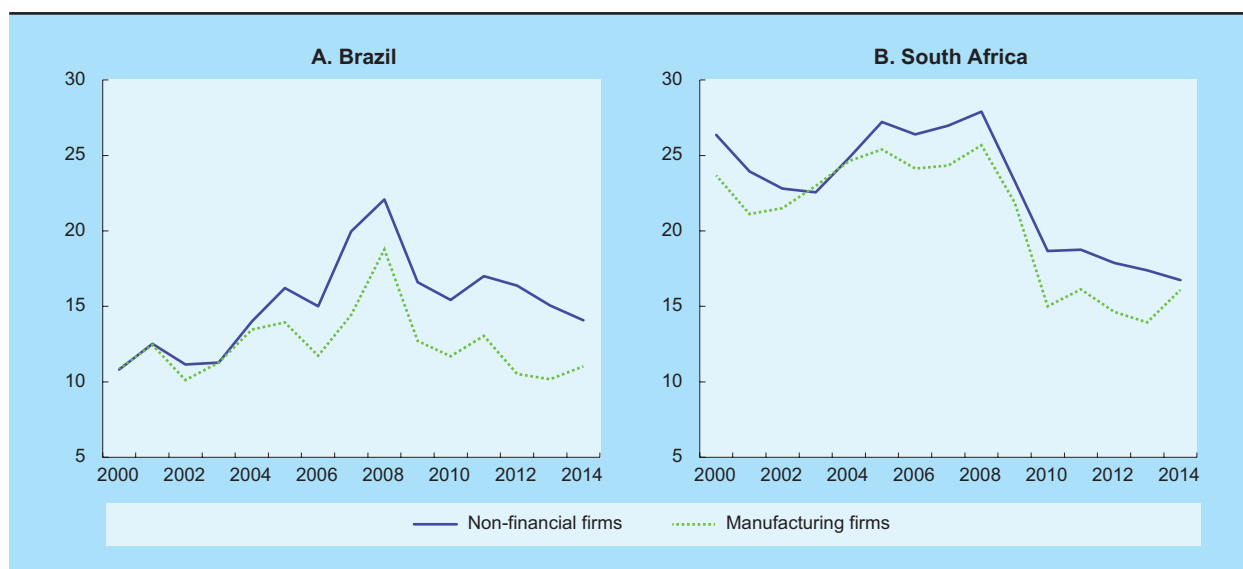
economic stability (Chui et al., 2016). Exposure to exchange rate risk is particularly high for companies in the non-tradable sector, as their revenues, which are in local currencies, do not provide natural hedges against such risks (IMF, 2015).

Chart 5.5 above presents the debt servicing ratios (DSR) of non-financial corporations in large developing and emerging economies between end 2007 and end 2015. DSRs reflect the share of (sectoral) income used to service debt, and are

Chart 5.6

### INVESTMENT AS A PROPORTION OF TOTAL CAPITAL STOCK OF NON-FINANCIAL AND MANUFACTURING FIRMS IN BRAZIL AND SOUTH AFRICA, 2000–2014

(Per cent)



Source: UNCTAD secretariat calculations, based on Thomson Reuters *Worldscope* database.

generally considered to be a reliable warning indicator of impending financial crises.

### 3. Structural transformation and finance for investment: Sectoral patterns of (financialized) investment

From the point of view of structural transformation and catch-up industrialization in developing economies, a core issue concerns the use of available finance, whether internally or externally sourced.

As mentioned in subsection D.1 of this chapter, despite an overall weakening of the profit-investment ratio in recent years, the 2000s were initially marked by an increase in investment rates in many developing economies. The commodity boom, which helped boost public investment programmes, played out differently in the various countries (see also chapter III, section E), as did the dynamics of their structural transformation processes. In China and the Republic

of Korea, the manufacturing sector grew robustly in the 2000s, against a backdrop of technological upgrading and productivity gains. Manufacturing also rose significantly (above 4 per cent per year) in Argentina, India, Indonesia, Thailand and Turkey between 2003 and 2011, in some cases recovering from steep contractions prior to that period. In contrast, the share of manufacturing declined in Brazil, Chile, Mexico, the Russian Federation and South Africa, with manufacturing value added growing at rather slow rates in real terms.

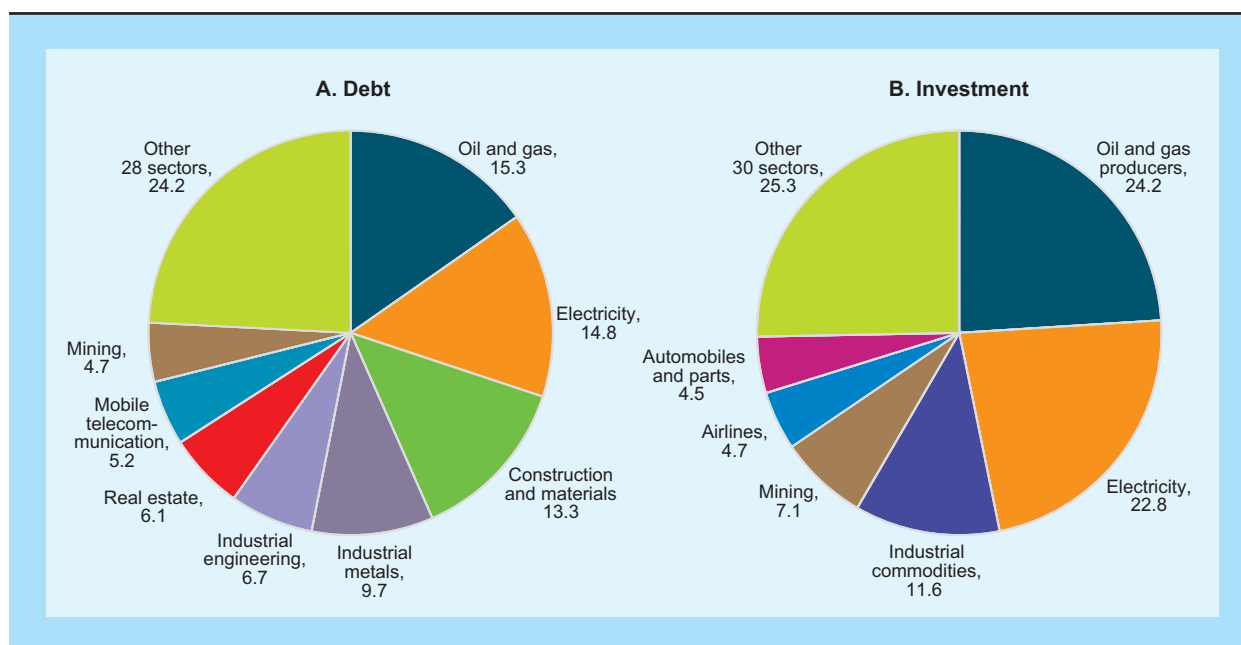
For Brazil, firm-level data show that, although overall investment rates picked up in the 2000s, manufacturing firms recorded a much more modest increase in investment. While the rate of capital accumulation in manufacturing firms was similar to that of other non-financial firms until 2003, this begun to change from 2004 onwards, with investment in manufacturing firms falling behind by 5.5 percentage points in 2007 and by 3.3 percentage points in 2008. From 2009, both types of firms showed declining rates, while maintaining a gap of 4 percentage points, on average, until 2014 (chart 5.6). Slower investment



Chart 5.7

### SECTORAL CONTRIBUTION TO THE INCREASE IN THE NOMINAL VALUE OF TOTAL DEBT AND CAPITAL STOCK BETWEEN 2010 AND 2014

(Per cent)



**Source:** UNCTAD secretariat calculations, based on Thomson Reuters *Worldscope* database.

**Note:** Chart shows aggregate data for the following countries: Argentina, Brazil, China, Chile, India, Indonesia, Malaysia, Mexico, the Republic of Korea, the Russian Federation, South Africa, Thailand and Turkey. The nominal value is in dollars.

growth in Brazilian manufacturing firms may be due to a sharp decline in the ratio of profit to fixed capital, from 26 per cent in 2004 to 14 per cent in 2008, a steeper decline compared with that of the larger universe of non-financial firms over the same period (from 24 per cent to 20 per cent). This slump in profitability was possible linked to a sharp nominal appreciation of the exchange rate during this period,<sup>14</sup> which eroded international competitiveness. Consequently, the worst affected were manufacturing industries that had a high exposure to international competition.

In South Africa, a divergence of investment rates between manufacturing and other non-financial firms also emerged from 2004 onwards, albeit to a lesser extent than in Brazil. The gap remained in the range of 2–2.5 percentage points until 2009, when both rates collapsed in the wake of the global financial crisis (chart 5.6). Unlike the profit rates of firms in Brazil, those of South African firms, especially manufacturing firms, increased between 2004 and 2008.

Another question concerns the extent to which large international capital inflows and the concomitant rise in corporate indebtedness across major developing and emerging economies, discussed in the preceding section, has helped or hindered the financing of productive investment activities since 2010. Palma (2015), for example, argues that the surge of cheap finance in the wake of QE programmes ended up financing primarily economic activities that do not enhance productive capacities (such as residential construction), as well as budget deficits and capital flight.

From a sectoral perspective, most of the increase in developing countries' corporate debt – 75 per cent – is attributable to companies in very few sectors: oil and gas, electricity, construction, industrial metals, automobiles (including trucks), real estate, mobile telecommunications and mining. Data show that these are also the sectors with the highest growth rates of investment (chart 5.7).

However, the patterns differ among countries. For example, in the Russian Federation, and to a lesser extent in Brazil, increases in both corporate debt and investment are highest in the oil and gas sector. Indeed, that sector accounts for most of the increase in the Russian Federation. In China, corporate debt rose fastest in construction, electricity, oil and gas, and real estate, whereas investment increased primarily in oil and gas, electricity and mining, but also in services. In other developing economies leveraged investment was more diversified, as it also targeted industrial goods (automobiles, consumer electronics and chemicals) in the Republic of Korea and the services sector

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Cheap finance in the wake of quantitative easing programmes ended up financing activities that do not enhance productive capacities.

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(mobile telecommunications, media and retail) in Mexico, for example.

Despite some heterogeneity in sectoral patterns and range, it is clear that easy access to cheap finance and debt-financing did not favour sectors situated close to the technological frontier and that had the greatest potential to contribute to overall productivity growth. Instead, leveraging and investment remained overwhelmingly concentrated in cyclical and natural-resource sectors. These sectors are particularly sensitive to changes in global growth and commodity price fluctuations, and are more prone to adding to macroeconomic and financial risks than to supporting structural transformation.

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## E. Reinvigorating investment in developing countries

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Economic growth and development are generally accompanied by the expansion of domestic financial systems and the diversification of sources of financing for investment. Despite this, internal finance, based mainly on retained profits, remains the main source of investment finance for companies in developed and developing countries alike (as shown in table 5.1 above). The weakening of the profit-investment nexus is therefore a reason for concern in countries at all levels of development, but in particular for countries that are aiming at accelerating a sustained process of structural transformation. Addressing this problem requires action on multiple fronts.

### 1. Tackling global financial instability and corporate financialization

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Reinforcing the profit-investment nexus requires first of all, a decided and coordinated effort by policymakers in developed economies to stabilize global

financial markets and stimulate aggregate demand so as to create more favourable macroeconomic conditions for investment and growth, especially in developing countries. So far, post-crisis policy responses in the source (developed) countries have focused far too much on extensive monetary accommodation, in particular through QE programmes.

It is by now clear that this overreliance on monetary policy in most European economies, combined with fiscal austerity, has not only failed to boost aggregate demand and output, but has also contributed to growing instabilities in the international financial markets and the renewed build-up of financial imbalances in many developing and emerging economies. Abundant cheap credit suddenly flooding these economies has supported asset price increases and increased exchange rate volatility, fuelling financial booms and busts, rather than facilitating sustained and productive capital accumulation.

The international policy coordination necessary to put in place global macroeconomic conditions

conducive to a sustained global recovery (discussed in chapter I) and to productive and long-term investment in developing economies has been lacking so far. However, increasing pressures from recently fast-growing financial imbalances across a wide range of economies may prompt a reassessment of the current policy approach.

Meanwhile, in the absence of international policy coordination to deliver public goods such as global financial stability, developing-country policy-

makers should adopt national and regional policy measures aimed at reducing the effects of global instability on their economies. A measure long advocated by previous *TDRs* has been capital account management to reduce speculative capital inflows and protect markets from excessive volatility, so as to create a macroeconomic environment that is supportive of productive investment and sustained productivity growth.

Moreover, national governments can influence the behaviour of non-financial corporations by providing them with incentives to invest, while discouraging the kind of financialization practices that hamper productive investment. Pro-investment incentives, such as preferential tax treatment for retained profits and special depreciation allowances, might encourage corporations to reinvest their profits rather than distribute them (*TDR 2008*: 124).

Current policy approaches to promote private investment are not generally geared towards establishing strong direct links between tax benefits for corporate profits and the use of those profits for reinvestment. An example is the widespread use of often substantial tax exemptions on profits for firms engaged in export-oriented activities without imposing any conditionality on the future use of those profits. It may be worth considering offering such tax benefits only for the reinvested share of profits, rather than exempting all profits derived from export-oriented activities.

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Pro-investment incentives, such as preferential tax treatment for retained profits, might encourage corporations to reinvest their profits rather than distribute them.

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Governments should consider prudential regulation and credit policies for long-term financing of priority productive activities.

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In addition, governments could use fiscal policy instruments to discourage financialization, such as reducing tax incentives for debt financing to encourage companies to give priority to equity finance instead (Aglietta and Brand, 2015).

Measures should also target banks and other financial institutions. The new liquidity requirements adopted under Basel III, including by many emerging economies, require banks to increase the amounts of highly liquid assets they hold

in order to withstand short-term outflows. Although this regulation addresses a major shortcoming of internationally active banks in that they rely too much on short-term wholesale funding, in simpler banking systems based on deposit funding, it may result in an excessive reduction of maturity transformation and of available long-term finance (see *TDR 2015*, chap. IV).

Developing-country governments may therefore be advised to give priority to implementing prudential regulations and credit policies that promote the long-term financing of targeted productive activities (*TDR 2015*). Currently, many countries count on major institutional investors, such as insurance companies, pension funds, mutual funds and sovereign wealth funds (SWFs), for long-term financing. This is, however, fraught with difficulties since there is no guarantee that savings deposited with institutional investors of this type will not also be drawn into “managing money” for short-term gains, in particular in the context of fierce competition with hedge funds and other speculative funds (*TDR 2015*, chap. VI). To counter this tendency, new capital market regulations could be designed to change the incentive structure for major institutional investors and asset managers. For example, regulators could require such investors to acquire a given proportion of their shares in

primary markets (i.e. to acquire newly issued bonds and stocks that increase firms’ equity). In addition, they could require asset managers with long-term

liabilities to hold a proportion of their total assets for a prescribed minimum period (Favereau, 2009).

Such measures would induce the adoption of a longer term horizon, thereby helping to reinvigorate the financing of investments at the macroeconomic level and promote a profit-investment nexus at the firm level. They could also help reverse the financialization trends in corporate strategies that have been observed over the past two decades.

## **2. Establishing a functioning profit-investment nexus in the context of catch-up development**

Much as developing-country corporate investment strategies matter to these countries' longer-term prospects for structural transformation, and are directly subject to the vagaries of capital flows and exchange rate pressures emanating from policy-making in developed economies (see box 5.2), the vast majority of small and medium-sized firms in developing countries operate domestically with little, if any, access to international financial markets. As table 5.1 shows, access to bank loans, let alone capital market financing, remains a major barrier to productive investment in poorer economies.

Strengthening the profit-investment nexus for such firms is all the more important. The experience of the Republic of Korea in this regard provides a valuable lesson, even though its success has been contingent on specific historical and global economic factors that cannot be replicated. The country adopted a two-pronged strategy to promote a functioning profit-investment nexus for its local firms. First, successive governments targeted both the demand and supply sides of firms. On the demand side, the strategy aimed at securing international markets for its goods through competitive pricing via centralized management of low real interest and exchange rates. On the supply side, the State safeguarded adequate levels of profitability in potentially competitive economic activities at the international level by closely monitoring domestic competition to avoid destructive impacts and by providing support for technological upgrading and innovation. Second, the State also supported the profit-investment nexus indirectly through financial repression (i.e. the targeted allocation of

monetary resources to priority sectors), while also aligning credit and liquidity provision closely with the changing external investment environment.

Today's developing countries face a more uphill task in this regard: the integration of economies as well as firms into global financial markets through capital account liberalization and the proliferation of international production chains are considerably more advanced than was the case when the Republic of Korea embarked on its catch-up industrialization.

An important corollary is that the financing needs of developing-country firms have become significantly affected by more complex organizational and production requirements, reflecting their exposure to highly internationalized production processes. This requires them to continuously improve quality and ensure price-competitiveness to secure and maintain their position in global value chains. While appropriate credit creation and liquidity provision by central banks remains essential for establishing a functioning profit-investment nexus, as does the channelling of finance to priority sectors via development banking, fine-tuned financing tools to encourage skills development should play an important role as well.

External financing and support by the State for entrepreneurs through long learning and gestation periods can take many forms, including facilitating access to inputs, and providing support to firms in sectors with the greatest potential to contribute to economy-wide productivity growth, including through preferential credit allocation, tariff policies, subsidies and tax reductions. It also includes financing collaborative technology learning centres to increase learning-by-doing skills. Successful experiences suggest that the main policy objective of any combination of such financing instruments ought to be rapid productivity growth. Which specific policy package may achieve this largely depends on the local, regional and national characteristics of firm, sectoral and market structures, prevailing State-business relationships and wider macroeconomic factors, such as stabilizing the exchange rate at a competitive level. The design of financing policies for industrial development therefore needs to be coordinated with wider industrial policy schemes that focus mainly on inducing entrepreneurs to increase productivity through learning-by-doing (Khan, 2009 and 2013).

## Box 5.2

### CREATING A DEVELOPMENT-ORIENTED FINANCIAL SYSTEM: THE ROLE OF THE CENTRAL BANK OF THE REPUBLIC OF KOREA

The key role played by the central bank of the Republic of Korea, the Bank of Korea, in the country's rapid growth and economic transformation provides an interesting lesson. The financial system instituted by the Government was designed to provide financial resources for rapid economic development. This system included not only development banks and specialized banks, but also commercial banks, which were nationalized in the early 1960s. All these institutions contributed to development both directly, by providing policy loans, and indirectly by providing resources for development. Specialized banks undertook on-lending operations. The mainstay of this system was the country's central bank, which played the critical role of provider of liquidity and guarantees.

A key feature of the Republic of Korea's financial system was the guarantee scheme, created in the 1960s to facilitate borrowing abroad to support indigenous technology and industrial development as opposed to relying on foreign technology and firms (Vittas and Cho, 1996; Cho and Kim, 1995). The Korea Development Bank (KDB) could borrow overseas and provide guarantees for foreign borrowing by the country's firms. Specifically, firms wishing to borrow abroad obtained approval from the Economic Planning Board, which was ratified by the National Assembly. Thereafter, the Bank of Korea issued a guarantee to the foreign lender and the KDB issued a guarantee to the central bank. Thus, while the borrower was committed to repaying the loan and carrying the exchange risk, the cost of the external loan was reduced due to the KDB, and especially the Bank of Korea, warranting the operations (Cole and Park, 1983).

The Republic of Korea's development finance system was therefore well coordinated, with the Bank of Korea working closely with commercial banks, development banks and specialized financial institutions to support an agreed development strategy. Policy-based loans accounted for about 50 per cent of the total credit available in the economy during the 1970s, and 30 per cent in the 1980s (Cho and Kim, 1995).

Clearly, today's candidates for catch-up industrial development are more constrained by international regulations to which they have signed up, which render similar subsidy schemes illegal under WTO and OECD rules. Nevertheless, within the policy space still available to them, their central banks can play an important role in supporting structural transformation (*TDR 2013*).

A central message for policymakers is therefore that there is no single optimal financial policy package for the promotion of structural change and industrialization that can be easily emulated. Rather, developing countries need to use their policy space to develop their own national and local sets of financing instruments and channels to support structural transformation. Although internal finance from retained profits still accounts for a large share of total investment finance, particularly in developing economies, rapid productivity growth can be sustained only if increased access to external sources of finance is available. By definition, innovative firms and startups cannot generally rely on past profits, and previous development experiences show that the share of

internal finance decreases for fast-growing firms, as they require increasing amounts of finance to sustain rapid capital accumulation. Moreover, expansion strategies based on enhancing market shares tend to erode profit margins (Singh, 1997).

In principle, such external funding can come from both capital markets and the banking system, but as pointed out above, despite accelerated integration into global financial markets, capital markets still only account for a small share in the total financing of developing-country firms, albeit with variations across developing regions. Capital markets play a greater role in firms financing strategies in East Asia (table 5.2), whereas bank-based finance remains the

main source of external financing for developing-country firms across all other regions. Nonetheless, deposit-taking banks, which dominate banking systems in developing countries, typically provide mainly short-term loans to finance firms' working capital and other short-term operations, in addition to trade finance. Countries aiming to accelerate growth and structural transformation will therefore need to find ways to support the development of a banking system capable of delivering long-term finance for development.

Central banks should play a crucial role in this respect (*TDRs 2008, 2013*). They can act as providers of liquidity, guarantees and other instruments to induce commercial banks to increase credit, including for productive investment projects (as the central bank of the Republic of Korea, see box 5.2). The provision of public guarantees can help commercial banks overcome lending barriers arising from uncertainties about expected returns and informational asymmetries. Such public guarantees will, however, need to be extended with caution to avoid a build-up of contingent liabilities on public balance sheets that can be costly in the event of a wide financial meltdown. Liquidity provision is also vital to help commercial banks cope with loan requests in times of short-term financial distress. More generally, through their financial policies, central banks can influence the direction of credit to firms undertaking productive investments for activities that are considered strategically important to the process of structural change overall, or to firms and sectors facing specific financing constraints, such as small and medium-sized enterprises and startups.

Thus, the process of structural transformation can greatly benefit from a diversified financial system that includes development banks. The latter differ from deposit-taking institutions in that they have a different liability structure based on more diversified funding and less short-term lending; and, critically, they have a specific mandate to support development-oriented projects.

A standard argument as to why development banks should be promoted is that such banks can compensate for the drawbacks of deposit-based financial

institutions that are often geared towards short-term lending. A major drawback is that these institutions usually lack sufficient funding for economic transformation, which a central bank can help reduce, albeit only partially, through the kind of financial policies outlined above. Economic transformation typically involves large-scale projects that require long-term finance, and thus implies risks that com-

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Progressive tax erosion is an important factor behind declining public investment. A major cause is the increasing aptitude of large corporations and high-net worth individuals to avoid and/or evade taxes.

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mercial banks are unwilling to undertake, even with central bank support. In addition, while many large-scale projects generate positive externalities, and therefore social returns, their private returns may not be very high. Development banks can also provide finance to new firms and to those investing in innovation, which do not have a track record in terms of payments or performance – some of

the criteria that traditional banks use when making decisions on loans.

These are market failures that development banks can help overcome. Fundamentally, though, development banks can be instrumental not just in addressing market failures, such as the lack of provision of long-term financing due to high risks and uncertainties, but in supporting a proactive development strategy.<sup>15</sup> Indeed, past country experiences show that development banks did play such a role: they were not only able to remove bottlenecks, but also had the capacity to anticipate future needs arising from rapid and transformative development (Hermann, 2010).<sup>16</sup>

### 3. Combating tax avoidance, evasion and capital flight

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Public investment in basic infrastructure, for example, remains essential to structural transformation. This raises the issue of fiscal space, since most forms of public sector support to structural transformation and industrialization constitute a burden on the public budget. On the other hand, successful boosting of industrial capacity and employment creation will generate public revenues, provided that administrative capacities for tax collection and

enforcement are sufficient and used appropriately. Moreover, as public investment normally complements and provides incentives to private investment, expanding public investment is a powerful means of triggering a virtuous circle of investment, income generation and growth.

Therefore, to achieve structural transformation, it will be necessary to reverse the steady decline in public investment witnessed both in developed and developing countries over the past decades. One important factor explaining this decline is the progressive erosion of the State's capacity to collect taxes to meet growing needs for government spending. A major cause of this tax erosion has been the increasing aptitude of large corporations and high-net-worth individuals (HNWIs) to avoid and/or evade taxes.<sup>17</sup>

Financial globalization has been at the heart of the growing phenomenon of tax avoidance and/or evasion. In the past few decades, it has allowed the emergence of a highly sophisticated offshore service industry, comprising international banks, law firms and very large accounting firms. Using tax havens as loci – part of its “modus operandi” – this industry provides professional services to assist conglomerates in the design of tax planning schemes with the ultimate goal of minimizing tax payments on a consolidated basis.<sup>18</sup> These banks and firms are what the literature calls “enablers”. Critically, they assist companies and HNWIs in the transfer of funds from high to low tax jurisdictions (or to so-called tax havens, where taxes are either extremely low or even non-existent) to avoid or evade taxes where the funds originate (Gaggero et al., 2016).<sup>19</sup>

In the case of a conglomerate, the transfer of funds usually takes place between its own affiliates, through various mechanisms, a major one being transfer mispricing. This involves the transfer of goods and services between affiliates of the same company (intra-firm transactions) where the price does not reflect the true value of the underlying assets. The purpose is to shift profits from high to low tax jurisdictions, and deductions and losses to high tax jurisdictions. This practice, which is one among many that several large international corporations are deploying in their strategies to enhance profits,

exacerbates the growing divergence between profits and investments highlighted in this chapter.<sup>20</sup>

Although it is difficult to make accurate estimates of revenue losses from tax avoidance and/or evasion, estimates reported in the past several years suggest that such losses are sizeable. This gives some idea of the challenges confronting developing countries in their efforts to enhance their capacity for collecting tax revenues to finance their development and economic transformation.

A number of attempts have been made in recent years to tackle international tax leakages. Most of these have been undertaken at the global level, given the international nature of the challenge, although regional, bilateral and national initiatives have also been reported (*TDR 2014*, chap. VI).

The OECD's *Report to G20 Development Working Group on the Impact of BEPS [base erosion and profit shifting]*<sup>21</sup> in *Low-Income Countries* highlights the fact that the poorer countries have the most to lose from BEPS, since corporate income tax constitutes a large proportion of their total revenues:

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Poorer countries need to improve their capacity to increase their tax revenues as part of the broader challenge of domestic resource mobilization.

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nearly 16 per cent, on average, in 2012 in the low- and lower-middle-income countries, compared with less than 9 per cent, on average, in the high-income countries (OECD, 2014a). Thus, tackling BEPS is of vital importance for helping developing countries improve their capacity to increase their tax revenues as part of the broader challenge of

domestic resource mobilization. According to the OECD report, the most important issues confronting these countries regarding BEPS include excessive payments to foreign affiliated companies in the form of interest, service charges, management fees and royalties; pressures to provide tax incentives; firms' profit shifting through corporate restructuring; and affiliates' use of techniques to obtain treaty benefits. These countries therefore face multiple challenges to resolve these problems, such as their lack of necessary legislative measures, and insufficient information and capacity to implement complex rules and challenge the MNEs (OECD, 2014b).

Notwithstanding these limitations, actions at the national level in developing countries have generated

concrete results. Examples include an increase in tax revenue in Kenya by \$33 million between 2012 and 2013 as a result of a training programme on advance transfer pricing; and transfer pricing adjustments of \$110 million in Viet Nam in 2013, following an increase in audits conducted by the tax authorities, as part of actions to enforce the country's transfer pricing rules (OECD, 2014b). These examples do not preclude actions at the international level, much to the contrary; but they show that measures taken by

developing countries can be effective in addressing the issue. What is also needed is for these countries to adapt the rules drawn internationally to their national context, in line with their own resources and implementation capacity. The need for adapting international rules also implies that the participation of developing countries in the design of international standards and rules to reduce tax erosion from BEPS and other practices is all the more important in their efforts to counter tax erosion.

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## F. Conclusions

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Structural change and higher rates of capital accumulation are impossible without adequate access to sources of finance. This is all the more relevant if, as has increasingly been the case, there is a steady rise in the minimum level of investment required to successfully launch an industrialization drive. A functioning profit-investment nexus is as vital for successful catch-up strategies and their continued financing as it was in early industrialization experiences.

However, a number of current global trends militate against a strong profit-investment nexus, and, in particular, against establishing a strong nexus in developing economies. Easier access to finance in the wake of capital account liberalization and financial market deregulation has not translated into increased financing for long-term investment for upgrading production capacities, especially in manufacturing. What is more, an excess supply of credit finance is not generally conducive to improved capital allocation among sectors, and may favour sectors with lower labour productivity, such as services, as well as lending to households.

Moreover, the financialization of corporate strategies and the rise of shareholder primacy in developed economies may have contributed to the worsening of income distribution and a deflationary bias through slower growth of global demand. A major feature of this trend has been that a growing share of corporate profits, rather than being used for

corporate reinvestment, is being used for purposes such as dividend payments and equity repurchases. This ultimately strengthens the role of financial intermediaries in capital allocation, which in turn contributes to economic instability and financial imbalances. This is because permanent revaluations provide frequent opportunities for investors to revise their financial commitments, and thus undermine long-term expectations. Real investment therefore becomes excessively dependent on the expectations of asset managers, and corporate strategies generally are turning more and more towards short-term, profit-seeking activities.

In order to establish and strengthen the profit-investment nexus, it is necessary to find ways of ensuring that private finance is once again used for productive purposes, in developed as well as developing countries. For large corporations, this requires, above all, reigning in the extreme short-termism that has come to dominate corporate decision-making by changing relevant incentive structures. This chapter has explored a number of options to help foster long-term investment strategies and support the use of long-term funding vehicles through regulatory and tax-related measures.

While the financialization of corporate strategies in developing and emerging economies has played a growing role in recent years – driven at least in part by policy changes in developed economies – it is



important to remember that corporations in these economies have less complex ownership structures. In addition, these firms are generally starved of external finance and have lower capacity to generate profits. Whereas the main challenge is to induce large corporations is to redirect their existing resources to productive purposes, the main policy task with regard to smaller firms is to facilitate their access to sources of external finance. Such access should be tailored to their specific needs in order to kick-start or enhance a virtuous circle of profit-investment dynamics and self-sustaining capital accumulation.

Establishing a strong profit-investment nexus requires substantial institutional and policy initiatives and change, including the creation or deepening of the banking system, ensuring it has appropriate capacities for long-term credit provision, along with proactive industrial policies. Developing-country governments

should design policies aimed at directly supporting their own process of catching up and structural transformation. Furthermore, governments can improve the macroeconomic environment through public investment on an appropriate scale to support infrastructural development and rapid economic transformation, thereby helping to increase private sector profitability. It is therefore vital to counteract current tendencies that diminish the State's investment capacities, including through taxation reforms both at the national and at the international levels. National initiatives in this regard are indispensable for the promotion of industrialization in developing economies. However, these alone are insufficient. For developing countries to achieve successful structural transformation, much deeper reforms of the international financial and monetary system will also be necessary, aimed at delivering financial stability and reliable sources of development finance. ■

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## Notes

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- 1 The World Bank's Enterprise Surveys reveal that, on average, more than 70 per cent of investment is financed internally in developing countries. The pattern of financing in the corporate sector varies substantially, both among different sized firms and among regional groups of countries. External financing is generally more prevalent among larger firms, whereas small firms rely more on retained earnings. In Africa, limited access to bank credit is a particularly severe constraint.
- 2 A hostile takeover is the acquisition of a company by another when management of the targeted company is not in accordance with the deal.
- 3 These conceptualized the corporate form either as a mere "nexus of contracts" (Jensen and Meckling, 1976) or as a "collection of assets" (Grossman and Hart, 1986). Corporations and firms therefore came to be viewed not as economic organizations with control structures and market power, but as voluntary contractual arrangements between owners of resources and as portfolios of assets with different rates of returns that could and should be traded to ensure maximum returns (Ireland, 1999).
- 4 A leveraged buyout is the acquisition of a company through borrowed resources. Its purpose is to allow the acquiring company to make large acquisitions without committing much of its own capital.
- 5 Indeed, restructuring also served the purpose of paying out shareholders through stock repurchases financed by the sale of assets (Krier, 2005).
- 6 Institutional investors are financial institutions that accept funds from third parties for investment not in their own name but on such parties' behalf.
- 7 The practice of buybacks has increased phenomenally over the years, particularly in the United States. In 1981–1982, companies listed on the S&P500 index used less than 4 per cent of their net income to repurchase shares, compared with almost 89 per cent in 2007. Buybacks have been particularly common among leading United States companies, many of which operate in the ICT and pharmaceutical industries. For example, in the 2000s,

- stock repurchases by Microsoft accounted for 89 per cent of its net income, by IBM for 91 per cent, by CISCO Systems for 130 per cent, and by Pfizer for 51 per cent. A proportion of these repurchases could have been spent, for example on research and development (R&D), but instead they amounted to 0.6–1.7 times their R&D expenditures between them. While cash-rich companies have undertaken massive buybacks, those with international operations have tended to keep cash offshore to avoid corporate taxes, and have, instead, taken on debt for the purpose of buybacks (Lazonick, 2013).
- 8 In the United States, exercised stock options accounted for 22 per cent of the average earnings of the top 100 chief executive officers (CEOs) in 1972, increasing to 63 per cent in the second half of the 1990s (Crotty, 2003).
  - 9 Focusing on European Union countries, Tori and Onaran (2015) highlight a number of stylized facts that show a declining investment-to-profit ratio, a growing ratio of financial assets to total assets, rising financial payments and incomes, and stagnant investment rates. They suggest that financialization has hit the manufacturing sector in the United Kingdom particularly hard. But Kliman and Williams (2014) provide an analytical and empirical critique of arguments that link financialization directly to a slowdown in real capital accumulation, using the United States as a case study.
  - 10 One possible reason is the lack of available data, as developing countries do not generally release a full set of integrated macroeconomic data about financial positions, and flows and stocks of assets and liabilities of households, government, firms and the rest of the world.
  - 11 The analysis is based on data from the balance sheets and income statements of 6,600 non-financial corporations of 13 developing economies – Argentina, Brazil, Chile, China, India, Indonesia, Malaysia, Mexico, the Republic of Korea, the Russian Federation, South Africa, Thailand and Turkey – obtained from Thompson Reuters *Worldscope* database.
  - 12 Demir (2009) shows empirically that this was indeed the case in Argentina, Mexico and Turkey, three emerging economies that promoted aggressive external financial liberalization in the 1980s (late 1970s in Argentina) and early 1990s. In all three countries, investment equations were estimated using firm level data which showed that the interest rate differential variable had a negative and significant impact on fixed investment levels between the early 1990s and early 2000s. Equations that used the share of financial assets in total assets as a dependent variable showed that the interest rate differential variable had a positive impact on financial assets.
  - 13 As possible explanations for carry trade activities by non-financial corporations, Caballero et al. (2015) point to tighter capital controls, incomplete financial markets and the retreat of global banks from emerging economies following the global financial crisis.
  - 14 The accumulated average nominal appreciation of the Brazilian real against the United States dollar was 60.1 per cent between 2004 and 2008.
  - 15 Development banks' role is not merely to correct market failures: they can also help create and shape markets and strategic policies for development (Mazzucato and Penna, 2014).
  - 16 In addition, development banks can act countercyclically, helping to sustain overall investment levels and reduce the vulnerability of the productive structure of a country during economic downturns. Protecting existing industries is important not only for facilitating a more rapid recovery, but also for encouraging the emergence of new and innovative industries critical for economic transformation (Hermann, 2010, based on Gerschenkron, 1962).
  - 17 Tax avoidance is the practice whereby companies and individuals exploit loopholes in the legislation to pay lower taxes. Tax evasion refers to a taxpayer's attempt to escape a tax liability under a country's law by concealing from the fiscal authorities the income and assets that are liable for taxes (*TDR 2014*).
  - 18 Tax planning involves a combination of advice on specific country legislation, a wide range of tax products and legal representation in tax litigation for the purpose of providing "the most beneficial tax structure for [their] clients" (Gaggero et al., 2016: 5).
  - 19 The term "enablers" was used in 2006 in a United States Senate report, entitled, *The United States Senate, Permanent SubCommittee on Investigations*.
  - 20 Tax avoidance also takes place through the transfer of activities, in addition to goods and services. Activities subject to transfer between jurisdictions often involve intangibles, such as marketing, and those linked to manufacturing such as local know-how or R&D. These intangibles are targeted because they are high-value-added activities. Their transfer takes place through business restructuring, whereby the local firm is "stripped" of such activities, becoming a "toll manufacturer" (OECD, 2010: 261). The stripping and transfer of activities occurs by taking them out of the balance sheets of the firms where they are created and placing them in the balance sheets of entities based in low-tax jurisdictions. The transfer, therefore, is book-based, or "fictional", as these activities are still generated by the "stripped" firm. The result is that the latter firm benefits from very limited incomes from such activities, thereby reducing the resources available for taxation.
  - 21 The OECD defines BEPS as "instances where the interaction of different tax rules leads to some part of the profits of MNEs [multinational enterprises] not being taxed at all. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place" (OECD, 2014a: 8).

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