FINANCIALISATION EMBROILS DEVELOPING COUNTRIES

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ABSTRACT.

Financialisation of developed countries includes increased lending to individuals as well as adoption of investment banking by commercial banks, thus contributing directly to the crisis of 2007-9. Financialisation has acquired an international aspect since the 1990s, primarily through liberalised capital flows. In the 2000s international financialisation has resulted in net capital flows from developing to developed countries, thus imposing substantial costs on the former, while subsidising the USA as leading issuer of quasi-world-money. International financialisation has also spurred domestic financialisation in developing countries through development of bond markets and foreign bank entry. Developing countries have been drawn into the crisis as current accounts declined and short-term capital flows were reversed.

KEYWORDS: Financialization, crisis, capital flows, developing countries.

JEL: B50, F30, G01, O16

INTRODUCTION.[1]

The global economic turmoil that began in August 2007 is a crisis of financialised capitalism. The crisis sprang out of the financial sector of the USA and the UK - the leading countries of financialisation - and entailed failure of the principal components of international banking. Through financial and trade mechanisms, it became a global recession affecting developed countries in which financialisation has made less domestic headway, such as Germany and Japan. The crisis then drew in a range of developing countries via the mechanisms of global trade and finance. This aspect of the crisis is the point of departure of this paper, affording an opportunity to analyse financialisation in the context of developing countries.

A necessary first step is to explain what is meant by financialisation, a term that has been increasingly used but without common agreement regarding its content. This essay draws on classical Marxist political economy and considers financialisation to be a structural transformation of core capitalist economies that has gathered momentum since the crisis of 1973-4.[2] In the first instance, financialisation stands for the rapid growth of the sphere of circulation, while the sphere of production has continued to face problems of profitability and productivity. Spurred by technological advance and the lifting of regulations during the last three decades, finance has grown enormously in terms of activities, markets, institutions and profits.

As finance expanded, relations between industrial enterprises, financial institutions and workers were transformed. These changes determine more precisely the content of financialisation. Thus, large industrial enterprises have become proficient at raising external finance in open financial markets, thereby acquiring financial functions and lessening their reliance on banks. There has been, in other words, financialisation of productive capital. Consequently, banks have sought new fields of profitability, two of which stand out.[3] First, banks have generated profits by mediating transactions in open markets. As a result, commercial banks have come increasingly to acquire investment banking functions. Second, banks have made profits by turning toward individual workers and others, for instance, by providing mortgages and unsecured loans.

[1] Thanks are due to several members of Research in Money and Finance at SOAS for critical comments and discussions over a period of months. Special mention should be made of Juan Pablo Painceira whose work has been important in developing some of the ideas put forth here. All errors are my responsibility.

[2] This approach to financialisation is discussed in Lapavitsas (2009, 2010) and draws on the output of the network Research in Money and Finance, see especially Dos Santos (2009, 2010).

[3] In this connection banks are a proxy for financial institutions. There is no doubt that financial institutions have proliferated in unprecedented ways in recent years, but banks remain the core of the financial system.

The new sources of bank profits are associated with what might be called the financialisation of the personal income of workers and others. During the last three decades there has been gradual withdrawal of public provision across a range of fields, such as housing, health, education, and so on. Growing reliance on private provision, coupled with stagnant real wages, has led to increased worker indebtedness to banks and other institutions. Meanwhile, retreat of public provision in pensions together with institutional and legal reform - including taxation - have channelled worker savings toward open financial markets across a range of developed countries. Banks have engaged in lending to individuals as well as handling assets arising out of personal income, thus earning interest spreads, fees and commissions. The extraction of financial profit directly out of wages and salaries, including from the poorest layers of workers, has elsewhere been called financial expropriation (Lapavitsas 2009).

These features of financialisation refer mostly to the domestic transformation of developed economies. Needless to say, the institutions of monetary and credit policy have also changed greatly, particularly the role of central banks. Furthermore, governance of corporate enterprises has been transformed, with emphasis on 'shareholder value', share prices and short-term results. Financialisation has finally had broader distributional, ethical and moral repercussions across society. Still, the characteristic features of financialisation across developed countries are not homogeneous, reflecting institutional, historical and political factors, including norms of business and personal income expenditure.

What matters more for the purposes of this article, however, are the international aspects of financialisation. This is a complex issue, ranging from the accounting standards of global financial transactions, to the altered role of international organisations, including the IMF, the World Bank and the WTO, to exchange rate policy and adoption of inflation targeting across the developing world, to the functioning of the dollar as quasi-world-money. The current crisis has touched upon these dimensions of financialisation, as was been made apparent in early accounts of its unfolding (Wade 2008, Gowan 2009).

Yet, the links between domestic financialisation in developed countries and international financialisation affecting developing countries remain unclear. These links derive in large part from the international capital flows between developed and developing countries. In this light, the role of international capital flows in the bubble of 2001-7 and in the ensuing crisis is considered in some detail below. It is shown that capital flows were important to sustaining the bubble in developed countries, while providing an effective subsidy to the USA as main provider of quasi-world-money. Moreover, international capital flows appear to have induced domestic financialisation in several developing countries, led by expansion of domestic bond markets and entry of foreign

banks. Capital flows and domestic financialisation have contributed to the emergence of crisis across a range of developing countries.

The article is structured as follows. Section 2 considers the main features of the bubble of 2001-7 that laid the ground for the current crisis. The bubble was an outcome of financialisation in so far as it emerged from the sphere of finance while having a marginal effect on productive accumulation. Specifically, the bubble arose primarily out of lending for private housing accompanied by intensive financial engineering (securitisation). Both the bubble and the ensuing crisis have thus reflected the structural shift of financial institutions toward personal income and mediating in financial markets.

Section 3 considers international financialisation and its impact on the domestic economy of developing countries. The issue is examined first in terms of capital and trade flows in the 2000s, showing that global capital has been flowing from poor to rich countries due to reserve accumulation. Apart from the benefits this trend has brought to the USA as the main issuer of quasi-world-money, it has also boosted domestic financialisation in developing countries. This has been exacerbated by entry of foreign banks.

Section 4 then turns to the impact of the crisis on developing and examines current account deterioration, short-term capital inflows and reserve accumulation. There is considerable variation among developing countries in this respect, which accounts for the differential impact of the crisis. Section 5 concludes.

1. BUBBLE AND CRISIS OF FINANCIALISATION, 2001-7.

The bubble of 2001-7 began as US monetary policy was loosened drastically after the collapse of stock market speculation during 1999-2000, bringing official Federal Reserve rates close to 1% during 2002-3. The epicentre of expansion lay in the US housing market, but other housing markets were also affected, notably in the UK. On the back of house price inflation, other financial asset prices also rose in the USA and elsewhere, creating a general financial bubble. The bubble grew as private banks moved into the US housing market, while engaging in financial engineering, above all, securitisation. It kept expanding after 2004 – when US interest rates began to rise – partly because of substantial capital inflows from developing countries.

Capital inflows from developing countries are considered in subsequent sections, but figure 1 shows the combined impact of private bank entry and financial engineering in the US housing market.

<Fig. 1 here>

Mortgage origination expanded rapidly on the wake of interest rate reductions in 2001. But growth in the prime market slackened after 2003, leading to a decline in total originations. Volumes remained at a high level, however, as subprime mortgages rose precisely at that time. Rapid subprime growth was possible because 80% of these mortgages were securitised, as is apparent from the diagram. In short, financial engineering enabled private banks to enter the housing market, even reaching previously excluded sections of US workers and thus sustaining growth of aggregate mortgage lending.[4]

The bubble, then, was partly due to the gradual transformation of banks in the course of financialisation, a process that is apparent for US banks. Namely, banks have turned increasingly toward investment banking, i.e. toward mediating in open financial markets to earn fees, commissions, and trading profits. This constitutes a significant change from traditional commercial banking which has typically involved gathering deposits to make customer-specific loans that were kept on the balance sheet. Securitisation represents a sharp acceleration of the trend toward investment banking, widely adopted by commercial banks since the 1990s.

Banks have also turned toward personal income as a source of profits, including the income of the poorest. Lending for personal mortgages in the 2000s represented an unprecedented sharpening of this trend for formal finance, which was made possible by two factors. The first was technological development which allowed general use of 'credit scoring' as well as risk management on the balance sheet. The second was the acquisition of investment banking functions by commercial banks, specifically the practice of borrowing short-term funds to finance the transformation of idiosyncratic loans into securities. [5]

It is worth stressing that the bubble was not a period of strong growth of consumption and investment, contrary to perceptions prevalent in public debate. Figure 2 shows that consumption as proportion of GDP remained stagnant during the period - or even declined in the UK and Germany – though remaining at very high historical levels in the USA. Weakness of consumption was related to lack of growth in real wages during this period. However, access of workers to consumer goods was improved as imports from Asia rose. Higher productivity growth in newly industrialising developing countries -

[4] For an account of the entry of private finance in previously 'redlined' areas of the housing market in the USA, thus drawing black and Latino families into the bubble, see Dymski (2009).
[5] See Lapavitsas (2009) for further discussion of these points.

primarily China – allowed workers in mature capitalist countries to maintain consumption levels. [6] But there was no consumption boom during the bubble.

<Fig. 2 here>

Indifferent consumption was matched by weak investment performance, particularly in the USA. Figure 3 shows that there was no investment boom in mature capitalist countries during the bubble of 2001-7. Rather, productive capitalist accumulation exhibited considerable weakness in the USA and other leading developing countries. This is in sharp contrast to the Japanese bubble of the late 1980s, which witnessed the last great splurge of domestic investment by Japanese enterprises. By the same token, the gearing of non-financial corporations did not rise significantly during 2001-7. The crisis of 2007-9 has not been caused by corporate over-indebtedness.

<Fig. 3 here>

What did rise at a remarkable pace during this period, however, was individual indebtedness in the USA and the UK, as is shown in figure 4. At the same time, individual indebtedness declined in Germany and Japan, and the reason obviously is that there was no housing bubble in those countries. Note that unsecured borrowing (primarily for consumption) did not rise strongly - and even declined after 2005 - in the USA and the UK. The ratio of debt to disposable income in the UK and the USA rose to unprecedented heights primarily because of mortgage borrowing. Given stagnant real wages, it is obvious that such extraordinary levels of personal debt were going to lead to problems as soon as interest rates rose significantly. This is indeed what happened in 2006, starting the slide toward crisis.

<Fig. 4 here>

Against this background, banks and the financial system in general expanded enormously in both the UK and the USA, though much less so in Germany and Japan. Figure 5 shows that UK bank assets rose to almost five times GDP, while US banks rose less prominently. The reason for the latter is the emergence of vast 'shadow banking' in the USA, including institutions that engaged in mortgage and other activities while being partially related to banks. Nevertheless, banks remained at the heart of financial expansion even in the USA by generating credit for others and sustaining flows

[6] For comparisons of rates of growth of productivity see Amiti and Stiroh (2007).

in money markets. It is no surprise that US banks found themselves at the centre of the crisis after 2007.

<Fig. 5 here>

As was mentioned earlier, banks undertook this enormous expansion by adopting investment banking practices. Mixing commercial with investment banking has had severe implications for bank performance and directly contributed to the outbreak of crisis. For, investment banking has different liquidity and solvency requirements from commercial banking. The latter relies heavily on deposit inflows for liquidity, while making customer-specific loans. It is necessary, therefore, for commercial banks to hold substantial capital in order to ensure solvency and confidence among liability holders. The former relies heavily on the money market for liquidity, while dealing in tradable securities. The capital requirements of investment banks are correspondingly lower.

In the course of the bubble commercial banks became heavily dependent on the money market for liquidity, while transforming customer-specific loans (mortgages) into tradable securities. This allowed banks to 'churn' their capital, thus raising their profitability. Moreover, since loans were rapidly securitised in complex ways that deployed computationally-intensive models, the process of information collection and risk management by banks lost much of its substantive content. The result was that housing loans in the USA around the middle of the 2000s were made on the flimsiest of foundations to borrowers of very low creditworthiness. Not surprisingly, as interest rates climbed in 2006-7, subprime mortgages started to default in large numbers. Thus, seemingly tradable securities created by banks became completely illiquid, while fresh funds from the money market dried up. Bank depositors, meanwhile, threatened to withdraw deposits *en masse*, most dramatically in the case of Northern Rock in the UK. The result was that banks found themselves in the midst of a systemic crisis of liquidity and solvency.

The recession that unfolded in 2008 was spurred by the banking crisis and the ensuing tightening of credit. Securitised pools of credit completely disappeared as financial institutions abandoned securitisation. Meanwhile, banks tightened credit provision in an attempt to improve liquidity and solvency. Laden with debt and confronted with collapsing housing markets, households drastically reduced borrowing, to the point of nearly eliminating all fresh borrowing by households in the USA toward the end of 2008. The result of these developments was collapse of demand, which has impacted on firm inventories, output and employment. By extension, exporters were severely hit, above all, in Germany and Japan, but also in developing countries, leading to general recession.

To recap, the crisis of 2007-9 is an outcome of financialisation. The crisis emerged after the burst of the gigantic bubble of 2001-7, which centred on the housing market of the USA and to a lesser extent the UK. Productive accumulation was only marginally affected by the extraordinary growth of finance during 2001-7. The bubble was caused, on the one hand, by loose monetary policy that resulted in cheap credit. On the other, it resulted from the turn of banks toward personal income as source of profits, while at the same time engaging in financial engineering.

Banks and other financial institutions expanded enormously during this period. Yet, the ultimate source of repayment for much of the credit advanced was worker income, which remained stagnant. The ensuing financial crisis forced rapid adjustments of liquidity and solvency for banks as well as attempts to lower indebtedness by workers. The recession that has emerged is likely to have significant effects on production and employment, thus also second order effects on finance.

2. INTERNATIONAL FINANCIALISATION IN THE COURSE OF THE BUBBLE.

The bubble of 2001-7 and the ensuing crisis have cast light on the international aspects of financialisation. As was mentioned above, financialisation is primarily a process occurring within developed countries. But financialisation has also affected the developing world, entailing structural transformation of financial systems as well as altering the interaction between domestic economy and global finance. At the same time financialisation of developing countries has also had specific features reflecting, first, the dominant role of developed countries in the world economy and, second, the mode of integration of particular developing countries with world markets.

The beginnings of financialisation in developing countries can probably be found in financial liberalisation in the 1970s, which lifted price and quantity controls in domestic financial systems. Following mediocre results in terms of investment, efficiency and stability, liberalisation gradually acquired further features, including introduction of stock markets. By the late 1980s financial liberalisation had morphed into an integrated pro-market development strategy, the Washington Consensus. Guided and enforced by the World Bank and the IMF, the Consensus led developing countries to alter the balance of domestic finance away from bank-based, relational, government-controlled toward market-based, arms length, private institutions and mechanisms.[7]

[7] For further analysis of several aspects of the Washington Consensus from a Marxist and heterodox standpoint see Fine, Lapavitsas and Pincus (2001) and Lapavitsas and Noguchi (2005).

A fundamental component of the Washington Consensus has been to open domestic economies to international capital markets, typically on the grounds that capital would flow from rich to poor countries, thus promoting development. However, it is shown below that in the 2000s, as developing countries became more closely integrated with world capital markets, precisely the reverse took place. Openness to international capital flows, moreover, drew developing countries into both the bubble of 2001-7 and the ensuing crisis. International financialisation has thus had highly unstable outcomes for developing countries.

A further component of the Washington Consensus has been strongly to encourage entry of foreign banks into developing countries. The rationale typically was that foreign banks would improve efficiency while meeting domestic credit shortages.[8] Yet, entry by foreign banks into developing countries since the 1990s has had unexpected results, including the redirection of bank lending toward personal income, thus strengthening domestic financialisation. The presence of foreign banks, furthermore, has affected the slide toward crisis in several developing countries. For these reasons the crisis of 2007-9 represents a major blow for the Washington Consensus. This has been clearly understood by its advocates, who have leapt to its defence (Demirguc-Kunt and Serven 2009).

In the following sections, financialisation of developing countries is considered in connection with capital flows and foreign bank entry. The conclusions are perhaps most appropriate for middle income countries in the period that followed the Asian crisis of 1997-8. It is shown that during the ensuing decade the mode of integration of developing countries with the world economy was transformed. As a result of this transformation net capital flows became strongly negative, substantial costs were imposed on developing countries, and domestic financial markets expanded. Moreover, systematic entry by foreign banks has promoted further internal financialisation with attendant phenomena that are reminiscent of the transformation of finance in developed countries. These developments have played an important role in the bubble of 2001-7, while also determining the impact of the crisis on developing countries.

2.1 Capital and trade flows.

The flows of international capital and trade after the Asian crisis of 1997-8 are important to the unfolding of financialisation.

[8] An influential formulation of this view can be found in Claessens, Demirguc-Kunt, and Huizinga (2001).

<Fig. 6 here>

A striking feature of Figure 6 is the growing divergence between private and official capital flows after 2002. During 2002-2007 private flows recovered strongly from their collapse at the end of the 1990s. Meanwhile, net official flows became negative, partly because aid flows were mediocre, but mostly because developing countries repaid official debts, especially debts to international organisations accumulated at the end of the 1990s. But similarly to the 1990s, the period of expansion in the 2000s has ended with collapsing private flows in 2008, although the ensuing crisis is likely to have different outcomes for reasons discussed below. Figure 7 affords further insight by showing the composition of private flows.

<Fig. 7 here>

Foreign Direct Investment has been by far the most vigorous component of private flows, sustaining itself even after the Asian crisis. FDI has so far successfully ridden the wave of the current crisis. On this evidence, productive capacity has continued to shift to developing countries throughout the last decade, primarily to Asia. This seems to be a firm underlying trend of the world economy.

Portfolio flows, on the other hand, have been weak and fluctuating throughout the period. Other short-term flows, including bank lending, remained weak until 2005, but during the last years of the bubble they recovered strongly, even if growth was far from uniform across developing countries, as is shown below. However, the expansion of short-term flows proved extremely precarious, and was sharply reversed once turmoil hit global finance in 2008. Strong growth and rapid decline of short-term flows were an important financial mechanism through which developing countries were drawn into the crisis.

Figure 6 also shows that, during this period, substantial current account surpluses emerged among developing countries. Developing countries have become more closely integrated into the world market since the 1980s as policies of trade liberalisation were generally adopted. This holds even for low-income countries in Africa and Asia, where the ratio of exports to GDP in 2007 stood at roughly 35% for the former and 30% for the latter (Karshenas 2009). Naturally, the behaviour of the current account has varied significantly among developing countries in the 2000s, depending on trade specialisation. However, two broad groups can be identified. The first comprises countries that have gained substantial share in international manufacturing, most prominently China. A significant part of their surpluses were exports to developed

countries, including consumer goods to the USA and Western Europe. The second comprises commodities exporters, most strongly oil exporters, including Russia and the Gulf countries, but also exporters of industrial metals. Rising commodity prices around the middle of the decade resulted in substantial trade surpluses, though less so for agricultural raw materials.

Generally speaking, expanding trade flows during the 2000s strengthened the integration of developing countries into the world market. By the same token, developing countries have become more vulnerable to global trade shocks. Since the crisis of 2007 led to collapsing demand in developed countries, manufacturing and commodities exporters among developing countries faced declining demand. The burst of the bubble in commodity prices in 2008, with the ensuing collapse of prices, intensified the effect on developing countries, thus creating conditions of recession. But the impact of the trade shock on developing countries has been far from uniform, as is shown in the following sections.

By far the most striking aspect of Figure 6, however, has been the growth of reserve holdings by developing countries. Indeed, the accumulation of reserves has been so strong that the net global flow of capital has been reversed. Thus, during the 2000s, capital has flowed from poor to rich countries on a large scale, an evidently pathological outcome of financial liberalisation that is contrary to the precepts of the Washington Consensus. [9] Reserve accumulation and the net outflow of capital from poor to rich countries have continued in the course of the crisis of 2007-9, though the pace has slackened.

Table 1 gives further detail on reserve accumulation by developing countries:

<Table 1 here>

China dominates reserve holdings, possessing more than a third of total reserves, and reflecting persistent current account surpluses. Significant other holders include oil exporters. The most remarkable holder of reserves, however, is surely Sub-Saharan Africa, which held roughly $163.5bn in 2008, an increase of roughly five-fold during the period. Even impoverished Africa contributed to the net flow of capital from poor to rich countries.

[9] Hence the process has caused some mainstream bafflement (Prasad, Rajan and Subramanian 2007).

There are several reasons why developing countries have been accumulating reserves in the 2000s. The shock of sudden reversal of private capital flows in 1997-8 encouraged adoption of a policy of 'self-insurance'. [10] Given that there was no structural change of global finance after the crises of the late 1990s, developing countries were left to fend for themselves in an environment of re-strengthened private flows in the 2000s. In that context, developing countries have exhibited some reluctance to rely on short-term and portfolio flows, though after 2005 several became heavily dependent. More significantly, developing countries sought ways of protecting themselves from the potentially disastrous implications of flow reversals, particularly after short-term borrowing began to rise again.

'Self-insurance' also applies to countries that have not generated regular current account surpluses but have still registered significant short-term capital inflows. Remarkably, it also applies to very poor countries that have relied on regular inflows of aid during this period, notably in Africa. Such 'self-insurance' has been actively enforced by the World Bank and the IMF, who have been monitoring the levels of reserves relative to exports and domestic monetary growth of even the poorest developing countries (Painceira 2009).

Reserve accumulation has also resulted from exchange rate policies. On the one hand, several developing countries with current account surpluses have attempted to prevent their exchange rates from rising. Pegging the exchange rate for trade purposes is a key reason why China has accumulated vast reserves. On the other hand, macroeconomic policies of inflation targeting were often forced on developing countries as part of the Washington Consensus. Inflation targeting has entailed pegging exchange rates relative to the dollar or other major currencies in an apparent effort to control imported inflation. To be able to defend the peg, developing countries have had to accumulate reserves. By the same token, several developing countries introduced high domestic interest rates, even resulting in rising exchange rates during this period. This encouraged forms of 'carry trade', that is, domestic residents borrowing abroad in order to invest in financial assets in developing countries (Painceira 2009). As borrowing abroad rose, so did the pressure to hold reserves.

2.2 Financialisation spurred by reserve accumulation.

The precise composition of international reserves is not known, but there is little doubt that the bulk - perhaps two thirds - comprises US dollars. The policy of reserve accumulation thus amounts to developing countries storing dollars – a total reserve

[10] An unfortunate euphemism for a policy forced on developing countries by the absence of structural change in world finance.

equivalent of about $6tr in 2008 - in order to be able to participate in international trade and confront financial flows. In Marxist terms, it is a policy of intensified hoarding of the dollar as quasi-world-money. [11] The extent of such hoarding by developing countries is unprecedented in the history of the world market, in view especially of the US dollar being ultimately backed by nothing more than US government securities. In effect, developing countries have been obliged to accumulate vast hoards of quasi-world-money that rests solely on the promise of the US government to pay an (intrinsically valueless) dollar for every dollar of its debt.

In these circumstances, the safest way for developing countries to accumulate dollars has been to purchase US public debt. Thus, the expansion of reserves by developing countries during the 2000s resulted in a growing share of US public securities in the possession of foreign financial institutions, primarily central banks.

<Fig. 8 here>

Specifically, an increasing proportion of US Treasury securities have been held abroad in the 2000s, rising from 35.2% of the total in 2000 to 56.9% in 2007. Even stronger than this, however, has been growth in the foreign holdings of long-term securities issued by the Government Sponsored Agencies that are the backbone of the US housing market. The proportion of GSA securities held abroad rose from 7.3% of the total in 2000 to 21.4% in 2007. Foreign buyers have treated these as quasi-public-debt, a perception that was fully borne out by the rush of the US government to nationalise 'Fannie Mae' and 'Freddie Mac' at the peak of the crisis in late summer 2008. Reserve accumulation has thus had a direct connection to the US housing bubble.

The impact of reserve accumulation on developed countries has been profound, though its analysis requires caution. At the peak of the US housing bubble in 2006, the net aggregate flow of capital from poor to rich countries stood at $700bn, rising to just over $800bn in 2008. These were significant sums relative to other international capital flows, and certainly represented massive outflows of capital from developing countries. But their size was rather modest compared to the fresh flows of credit in the US financial system, and even in the US housing market. The annual average of subprime mortgage originations alone was close to $600bn during 2004-6. Thus, the course of the US bubble was determined primarily by domestic credit conditions as well as by financial engineering by banks, as was discussed in section 2.

[11] World money is a particular function of money within Marxist theory that refers to money as hoarding and paying instrument in the world market (Marx, 1976, ch. 3). The traditional form of world money has been commodity money, i.e. gold, which is why the dollar is referred to as quasi-world-money in this article.

On the other hand, net inflows from developing countries, which became truly sizeable only after 2004, as Figure 6 shows, probably had a significant impact on US credit conditions at the margin. This is all the more so since they rose to prominence at a time when the Federal Reserve began to raise interest rates. It is reasonable to surmise that rising net capital flows from developing countries – primarily China – kept yields low in developed country markets, thus protracting the bubble.

The impact of reserve accumulation on developing countries, meanwhile, has been even more pronounced. For one thing, rising hoards of quasi-world-money have entailed substantial costs for developing countries. Given that much of this hoarding takes the form of US public securities, the growth of reserves has represented net lending by developing countries to the USA. These are funds that could have been invested domestically to support development. Put differently, the international arrangements of capital flows and world money have created an unprecedented source of gain for the US economy. Developing countries have been implicitly subsidising the hegemonic power in the world economy purely because it issues the dominant form of (valueless) quasi-world-money.

The cost of reserve holding for developing countries can be gauged through a variety of methods. [12] One way is to focus on countries that have received significant inflows of private short-term capital, and were then obliged to keep sizeable reserves in order to offset the risk of sudden reversal. In effect, these developing countries have received significant flows of borrowing from abroad - incurred by private enterprises - and proceeded to 'insure' it by lending officially to the USA. But the borrowing was at commercial rates of interest, while the 'insurance' at much lower official US rates. In a pioneering study, Rodrik (2006) estimated the social cost of this policy at perhaps 1% of developing country GDP.

Note, that the beneficiaries of this largesse by the global poor include not only the USA but also private borrowers in developing countries. For, private enterprises and others in developing countries were able to borrow abroad at rates that were typically lower than domestic rates, while 'insuring' their actions via costs that were effectively borne by society as a whole. Borrowers would frequently use the proceeds to invest in domestic financial assets, in a form of 'carry trade' that accrued directly the benefits of interest rate spreads. Reserve accumulation, in other words, induced internal differentiation in developing countries, further discussed below.

For countries that run significant current account surpluses, or for poor countries in receipt of foreign aid, the cost can be gauged in a different way that focuses on monetary policy (Wijnholds and Sondergaad, 2007, Aizenman and Glick, 2008). Acquisition of reserves by central banks is typically sterilised to prevent domestic

[12] Without even counting the risk of capital losses, if the dollar depreciated significantly.

monetary growth that could jeopardise inflation targets. But the liabilities thereby issued by central banks typically carry domestic rates, which tend to be significantly higher than the official rates on the foreign public assets also acquired by central banks. The spread is a cost that is carried by society as a whole. The main beneficiary is, once again, the USA, but there are also significant domestic implications for the financial systems of developing countries.

The domestic counterpart to reserve accumulation, therefore, has been increased domestic issuing of public securities across a range of developing countries. Domestic bond markets have grown strongly in developing countries since the middle of the 1990s, as is shown in Figure 9.

<Fig. 9 here>

Not surprisingly, domestic bond markets have grown most strongly in Asia, which also holds by far the largest reserves. But they have also become substantial in Latin America and elsewhere. The growth of bond markets represents increased financial deepening in developing countries and is an aspect of advancing domestic financialisation. Liquid public securities have provided a foundation for a variety of domestic financial transactions as well as for emergence of new financial institutions in developing countries. Liquid domestic markets have also made it possible for domestic banks increasingly to engage in activities that resemble those of developed countries. This trend has been accelerated by the entry of foreign banks in developing countries, discussed below. Thus, reserve accumulation, which arose due to the international aspect of financialisation, has boosted domestic financialisation in developing countries.

2.3 Financialisation accelerated by foreign bank entry.

The acceleration of financialisation as domestic financial markets have expanded is easier to see in middle income countries. A decisive element in this process has been foreign bank entry, which has taken place across developing countries in the course of the last decade. Significant proportions of total banking assets are now foreign-owned even in low income countries, most notably in Africa where foreign ownership constitutes more than two thirds of banking assets in ten countries. [13] There has also been pronounced foreign bank entry in Central and Eastern Europe. It appears that banking was exceptionally profitable in larger middle-income countries during this period, thus attracting foreign entry (WEO 2008).

[13] Namely, Benin, Cape Verde, Togo, Uganda, The Gambia, Mozambique, Zambia, Guinea, Djibouti and Lesotho (Karhenas 2009).

Entry of foreign banks into developing countries has complex outcomes on growth as well as on the performance of the financial sector. Its advocates expect the superior efficiency of foreign banks to improve the performance of domestic financial systems as well as ameliorating persistent credit shortages for small and medium enterprises (Claessens, Demirguc-Kunt and Huizinga 2001, Clarke, Cull, Sanchez, and Peria 2003). Even mainstream economists, however, have doubts on whether the skills of foreign banks in assessing 'hard' information are appropriate for lending to small and medium enterprise in developing countries, which tends to rely on 'soft' information (Detragiache, Tressel, and Gupta 2006).

For the purposes of this article, a notable outcome of foreign bank entry has been the introduction of lending practices that aim at personal income, particularly in middle income countries in the 2000s. Foreign banks have expanded provision of mortgage and credit-card lending as well as related financial services in a range of developing countries. Furthermore, growing volumes of lending and high profitability seem to have attracted domestic banks into the field, thus accelerating the financialisation of personal income. Personal indebtedness has emerged as a significant feature of several developing countries. The evidence is still patchy, but the pace of change has been startling in several middle-income countries.

Consider, for instance, Mexico and Turkey, both paradigmatic instances of middle-income countries with strong foreign bank entry. In Mexico, roughly 80% of bank assets are currently in foreign hands, particularly after a wave of mergers and acquisitions around 2000. Banorte is the only sizeable bank that remains under domestic ownership. Table 2 shows the proportion of consumer loans in total loans by the largest five banks at the time of mergers and a few years later. The turn of banks toward personal income as source of profits is apparent:

<Table 2 here>

Similar results obtain for Turkey, where the entry of foreign banks began in full earnest following the crisis of 2001 and the ensuing stabilization measures. Foreign direct investment increased very rapidly during 2002-7, exceeding $19bn in 2007 (Undersecretariat of the Treasury, Turkey, 2008). The financial sector was the main recipient of these flows mostly through mergers and acquisitions. Finance, for instance, absorbed almost 60% of the inflow of FDI in 2007. Led by foreign banks, the Turkish banking sector has swung sharply toward personal income as a field of lending, particularly after 2004. [14] Consumer loans by foreign banks have consistently exceeded 35% of their total loans since 2004, while the proportion of consumer loans by the

[14] For a fuller discussion of this trend see Ergüneş (2009).

banking system as a whole rose from about 13% in 2002 to about 33% in 2007 (BAT 2008). Housing loans rose, but the increase was most pronounced in credit card and related loans. Figure 10 shows the trajectory of individual debt and interest payments:

<Fig. 10 here>

Given that real wages have been stagnating, or even declining, in Turkey during the 2000s, the result of banks turning toward personal income has been extremely rapid growth of individual indebtedness. Meanwhile, there is no evidence that small and medium enterprises have benefited significantly from foreign bank entry. The longer-term implications for growth and development are far from clear.

To recap, the 2000s have been a period of accelerated integration of developing countries in world trade and finance, though with significant variations. This has lent an international as well as domestic aspect to financialisation in developing countries. Specifically, the 2000s have witnessed strong FDI and increasing short-term lending, but indifferent portfolio flows from developed to developing countries. At the same time, developing countries registered large current account surpluses through rising commodity prices and manufacturing exports. Above all, there has been enormous accumulation of foreign exchange reserves by developing countries, resulting in negative net capital flows. In effect, poor countries have financed a select few among the rich countries - mostly the USA - throughout the 2000s.

Put differently, international financialisation has led to developing countries holding enormous hoards of dollars (and a few other currencies) as quasi-world-money. The costs to developing countries have been substantial, gauged either as the spread between domestic and foreign interest rates, or as costs of sterilization by central banks. In effect, developing countries have been providing an implicit subsidy to some developed countries, mostly to the hegemonic issuer of quasi-world-money, the USA. The net inflows of capital from developing countries, meanwhile, allowed the housing bubble to continue apace in the USA after 2004.

Equally important is the growth of domestic financial markets fostered by reserve accumulation in developing countries, thus also boosting domestic financialisation. The latter has been further spurred by foreign bank entry which brought increasing proportions of bank assets in developing countries under foreign ownership. It appears that in middle-income countries foreign banks have led a shift of the entire banking system toward personal income as source of financial profits. Domestic financial expropriation seems to have taken root in several developing countries, with significant implications for individual indebtedness.

3. DEVELOPING COUNTRIES CAUGHT IN THE BURST OF THE BUBBLE.

The impact of the current crisis on developing countries is now easier to ascertain, if only in broad outline. It was shown in section 2 that the crisis arose due to financialisation in the USA and the UK, entailing large-scale lending to the poorest layers of workers while banks engaged in financial engineering associated with investment banking. The financial crisis became a general recession as demand collapsed and credit was tightened. Developing countries were caught in the crisis through several mechanisms associated with international financialisation.

In the first instance developing countries were hit by collapsing exports as demand disappeared in developed countries. Commodity exporters were also heavily affected as commodity prices fell rapidly in the second half of 2008. Current accounts thus worsened significantly across a range of developing countries. However, the intensity of the trade blow has varied according to the mode of integration of particular countries with the world economy.

Figure 11 shows the deterioration of the current account of several key developing countries in 2008-9. Significant deficits emerged for Poland, Brazil, India, while the exports of China also came under pressure.

<Fig. 11 here>

The crisis also affected developing countries through financial mechanisms, which to an extent overlapped with trade mechanisms. Thus, as liquidity disappeared among international banks, trade credit became scarce, affecting exports by developing countries. More pressingly, short-term capital flows were reversed as global credit conditions became tight, as was shown in Figure 7. Once again, the impact of the reversal of short-term flows varied according to the mode of integration with the world economy.

The most severe outcomes appeared when the reversal of short-term flows combined with rapid deterioration of the current account. The result was emergence of currency crises, reminiscent of the Asian crisis of 1997-8, which necessitated emergency borrowing and the intervention of international organizations, most pressingly in Eastern Europe. The accumulation of reserves in the previous period proved of limited

usefulness on those occasions. The complexity of the crisis was even greater in countries in which there had been significant domestic financialisation led by foreign bank entry, as was again often the case in Eastern Europe. Large domestic indebtedness combined with tighter international credit conditions to accelerate the deterioration of the domestic economy.

General trends as well as major differences among developing countries can be identifying by using aggregate IMF data that refer to standard regions, at some risk of losing significant detail. Figures 12, 13, 14, and 15 compare and contrast the Middle East, Latin America, Central and Eastern Europe and Emerging Asia. Thus, the worsening of the current account was most notable in Central and Eastern Europe as well as in Latin America. In contrast, the Middle East continued to register increasing surpluses even in 2008, while Emerging Asia remained broadly stable.

<Fig. 12, 13, 14, 15 here>

The shock of current account deterioration varied among the different areas. Things were at their worst in Central and Eastern Europe, which had registered deficits throughout the 2000s, and altogether failed to participate in the general trend of developing countries toward current account surpluses. Latin America was a distant second, switching to deficit in 2008, though on a significant smaller scale.

The impact of the current account shock also depended on the size of reserves held. The trend toward reserve accumulation continued in 2008, as was mentioned above, albeit at a reduced pace. However, the distribution of reserves has varied substantially among developing countries. Central and Eastern Europe was in a weak position, holding roughly half the reserves of Latin America and a fraction of the reserves of Developing Asia and the Middle East.

But the decisive element that determined the drift of developing countries toward crisis in 2008 was the extent to which they had come to depend on short-term capital flows in the preceding period. Figure 7 showed that such flows remained weak for most of the 2000s, though they rose sharply after 2005 as the bubble in the USA countries began to reach its peak. Still, there was considerable variation among developing countries in this respect. Central and Eastern Europe was the only region in the world that registered significant and rising short-term flows throughout the 2000s. Inflows of short-term capital were far more modest in other regions, barely rising into positive territory.

The sudden reversal of short-term flows in 2008 resulted in extreme difficulty of obtaining short-term credit, thus compounding the effect of current account deterioration. Countries that held substantial reserves were in a better position to deal with the combined blow. Central and Eastern Europe had registered high short-term flows in the preceding period, faced pronounced current account deterioration, and held lower reserves than elsewhere. During the previous period, furthermore, there had been sustained foreign bank entry that promoted domestic financialisation with rising levels of individual indebtedness. It is not surprising that the crisis was at its sharpest in Central and Eastern Europe, though the underlying reasons were present across developing countries.

4. CONCLUSION.

The crisis of 2007-9 arose at the burst of an enormous bubble in real estate and other financial assets primarily in the USA. The underlying trends that lead to it are characteristic of financialisation in developed countries. They include, above all, generalized lending to workers accompanied by financial engineering and adoption of investment banking practices by banks. The crisis mutated into a global recession as credit shrunk and demand collapsed. At that point it became clear that financialisation had embroiled developing countries.

Financialisation in developing countries is, in the first instance, a phenomenon of international transactions. Liberalisation of capital flows has integrated developing countries more closely into world capital markets since the early 1990s. The Asian crisis of 1997-8 did not stop this process, but gave to it a significantly different aspect in the 2000s. Developing countries were obliged to hoard quasi-world-money in order to be able to participate in international capital flows. The unprecedented extent of such hoarding resulted in negative net flows of capital, in effect poor financing rich countries - primarily the USA. To sustain reserve accumulation, meanwhile, developing countries engaged in sterilization. Consequently, international financialisation imposed substantial costs on developing countries, since interest rates on foreign exchange reserves were generally lower than either international borrowing rates, or domestic public security rates. Put differently, developing countries paid an implicit subsidy to the USA as issuer of the pre-eminent form of quasi-world-money purely because of taking part in international capital flows.

International financialisation, meanwhile, acted as a spur for accelerated domestic financialisation, particularly in middle income countries. Sterilisation encouraged growth of domestic bond markets, thus providing scope for expansion of domestic financial institutions. During the same period large-scale entry of foreign banks led to adoption of

practices found in financialised developed countries. In particular, lending to individuals for mortgages and consumption has risen prominently in several developing countries, resulting in rapid growth of personal debt. Domestic banks have also entered this field. The development results of directing credit toward personal income are unclear at present.

The impact of the crisis on developing countries has varied according to the mode and extent of integration in world trade and capital flows. Developing countries were hit by a combination of worsening current account and sudden reversal of short-term capital flows. The effect depended on the size of foreign exchange reserves. It also depended on entry by foreign banks and the extent of domestic financialisation. Central and Eastern Europe represented a particularly acute combination of these pressures.

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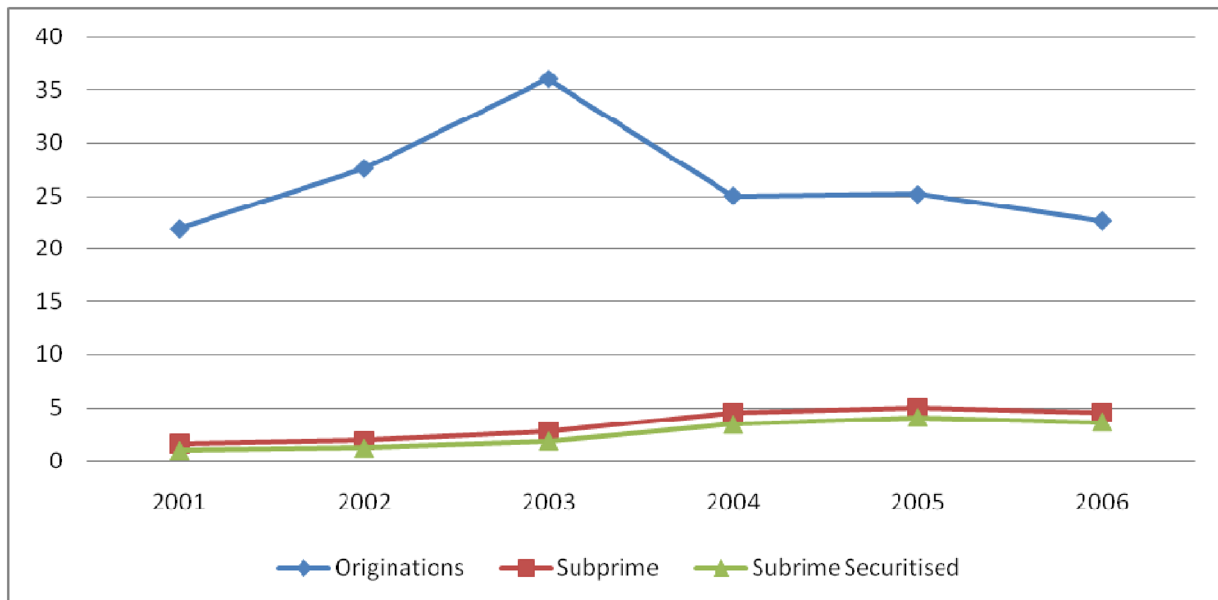
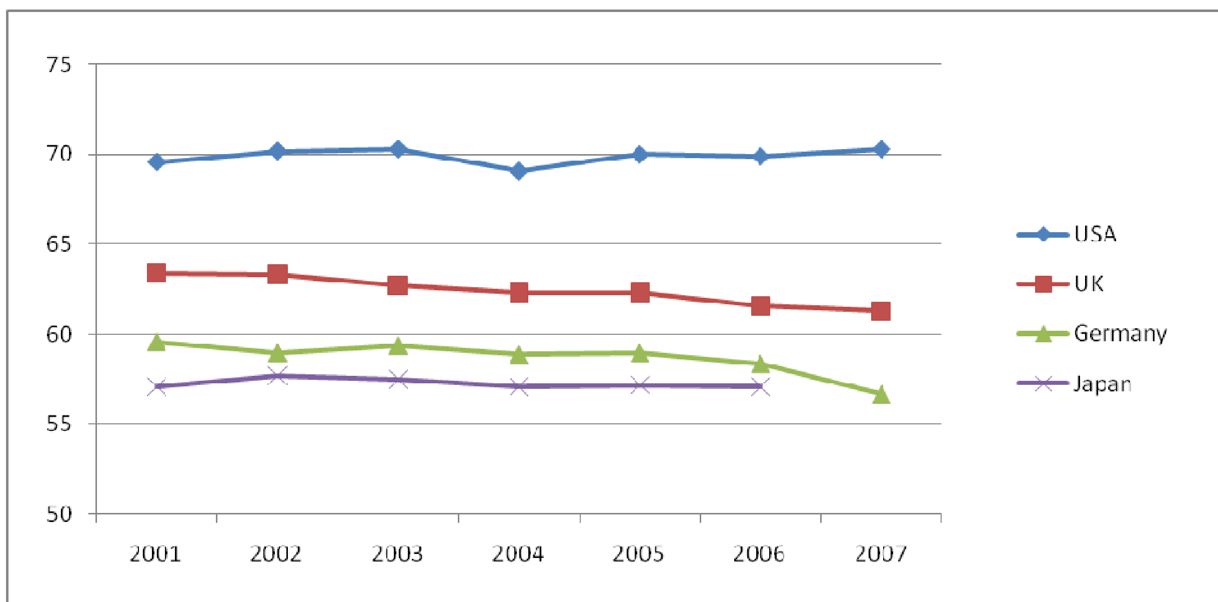
Fig. 1. US Mortgage Loans, % of GDP



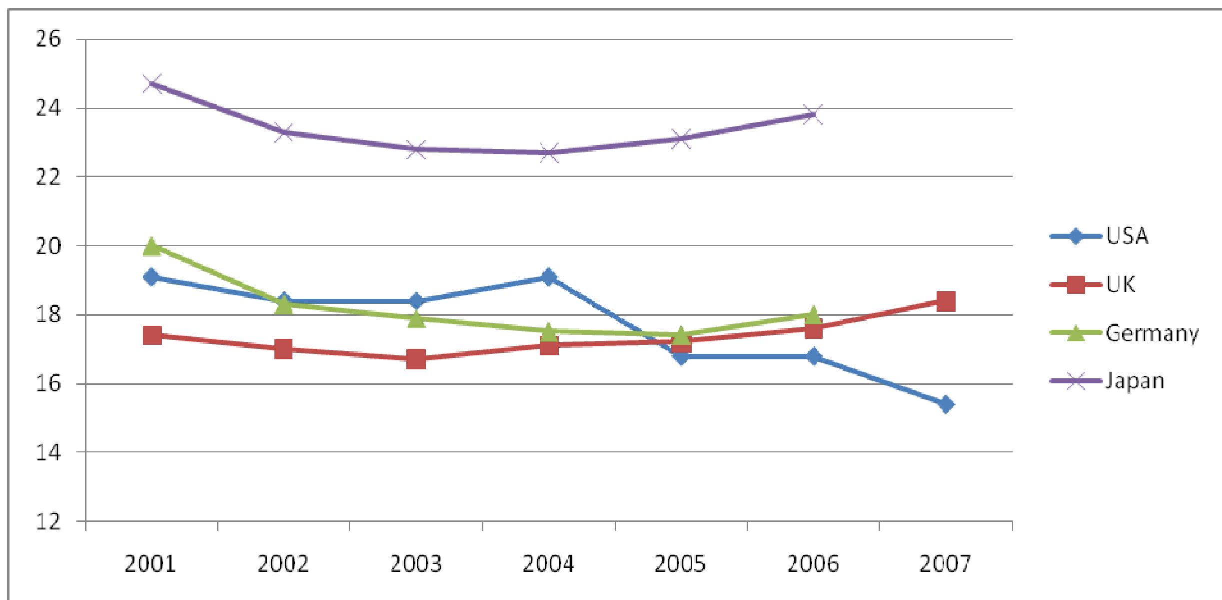
Source: Mortgage Bankers Association, various.

Fig. 2. Consumption as % of GDP



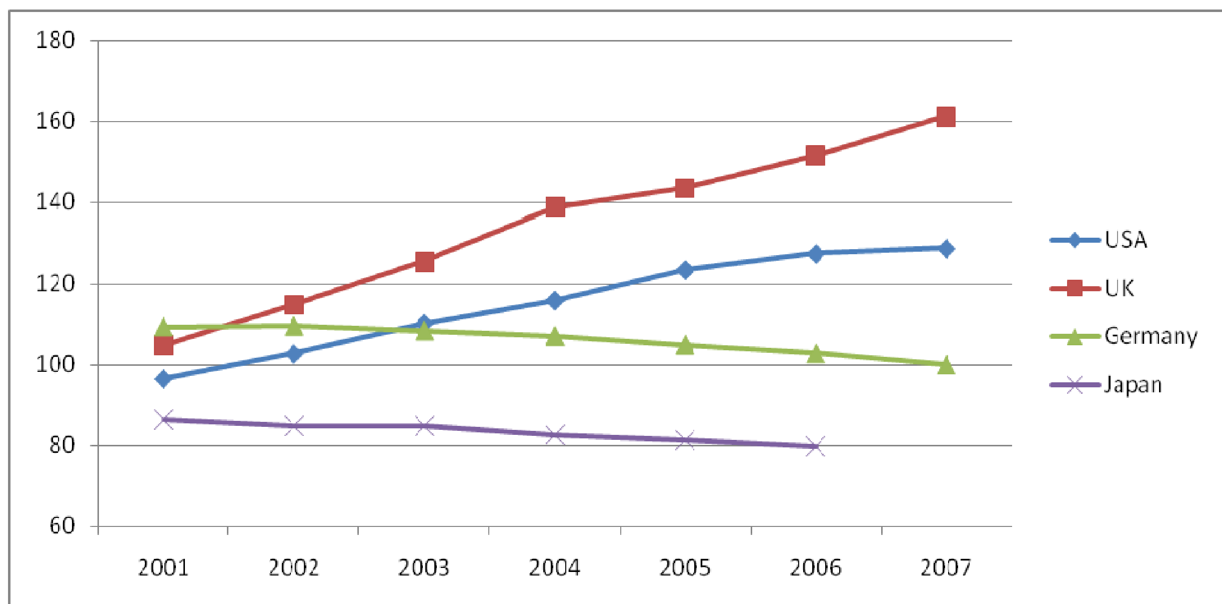
Source: Federal Reserve Flow of Funds, ONS, Bundesbank Flow of Funds, BoJ Flow of Funds

Fig 3. Investment as % of GDP



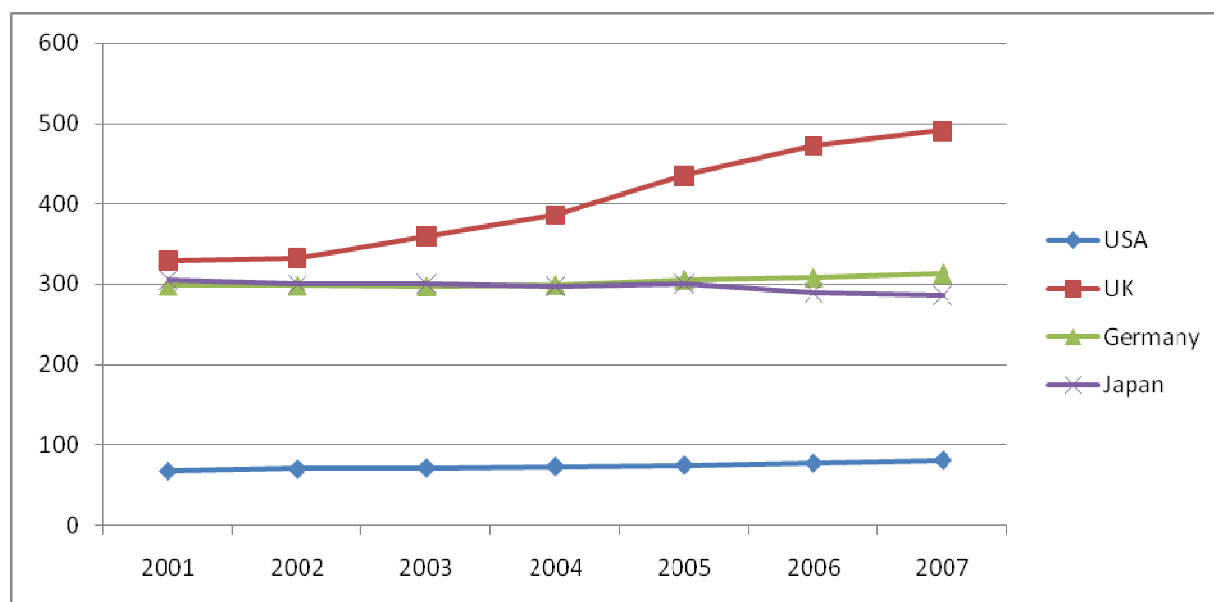
Source: OECD, Federal Reserve Flow of Funds, ONS

Fig. 4. Individual Debt as % of Disposable Income



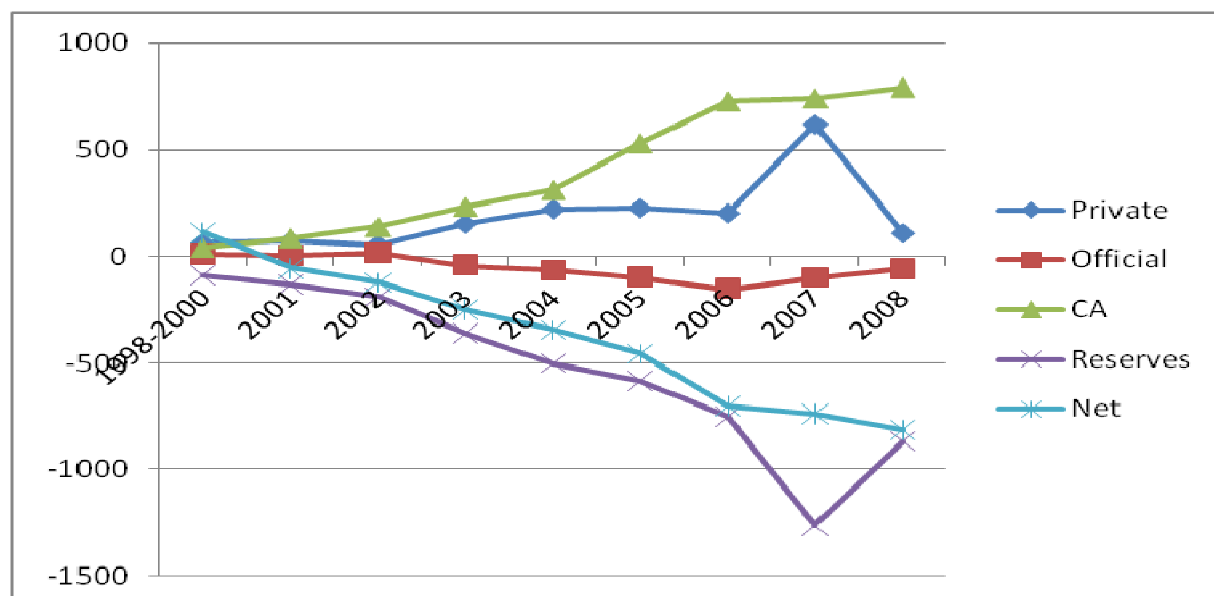
Source: Federal Reserve Flow of Funds, ONS, Bundesbank Flow of Funds, BoJ Flow of Funds

Fig. 5. Bank assets as % of GDP



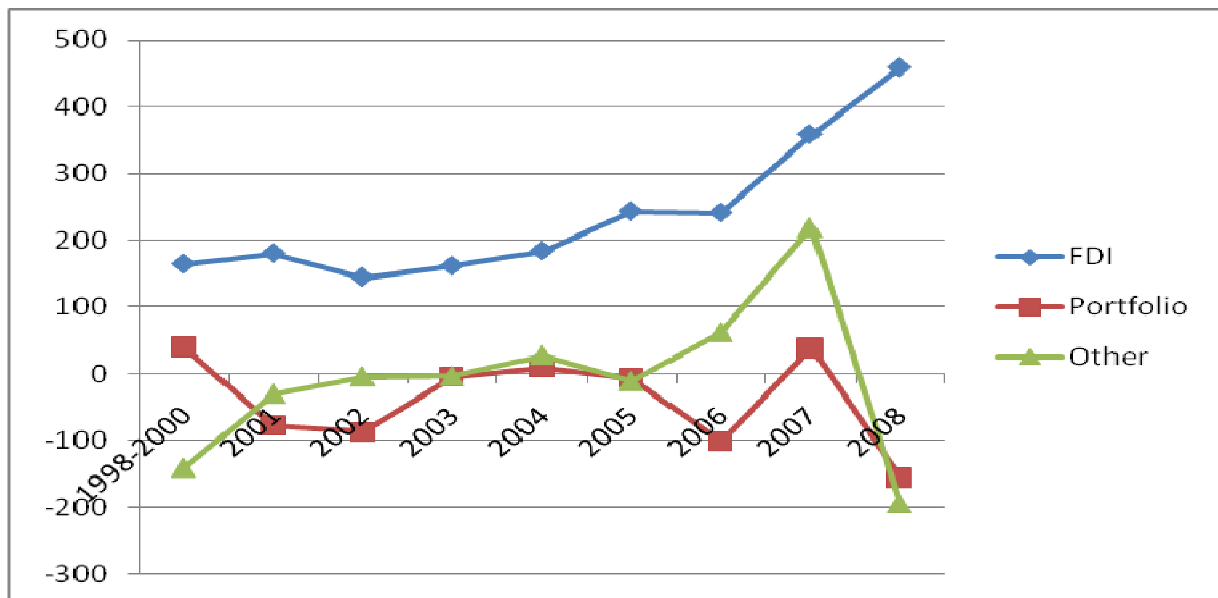
Source: Federal Reserve Flow of Funds, ONS, Bundesbank Flow of Funds, BoJ Flow of Funds

Fig. 6. Net Global Capital Flows - Emerging and Developing Countries, $bn



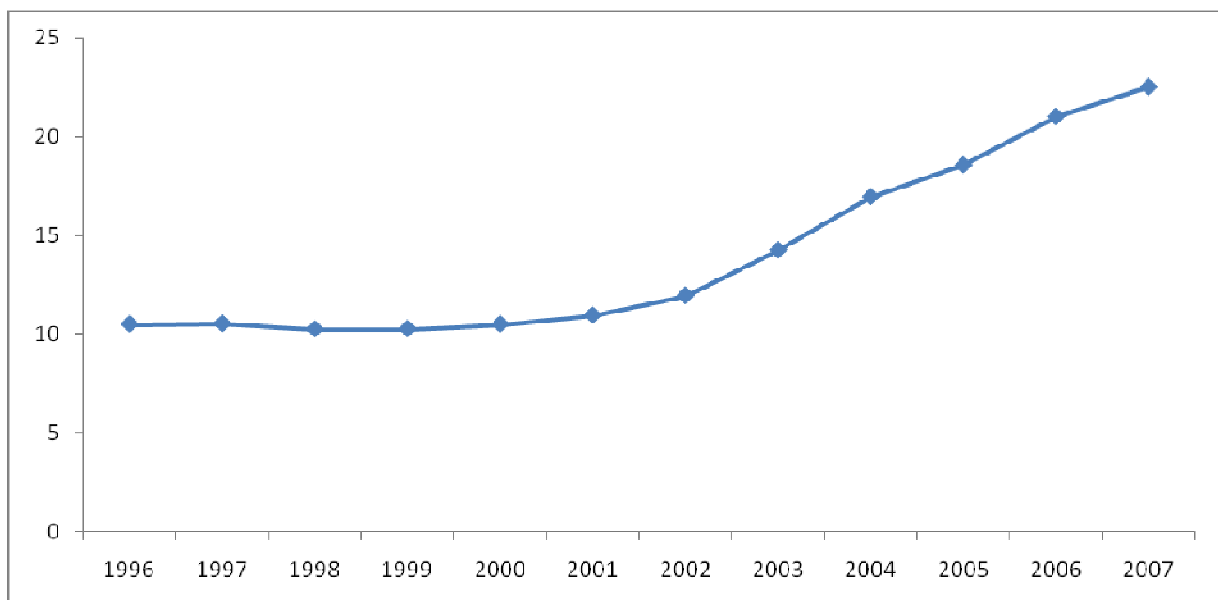
Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private. Source: WEO, 2009

Fig. 7. Private capital flows - Emerging and Developing Countries, $bn



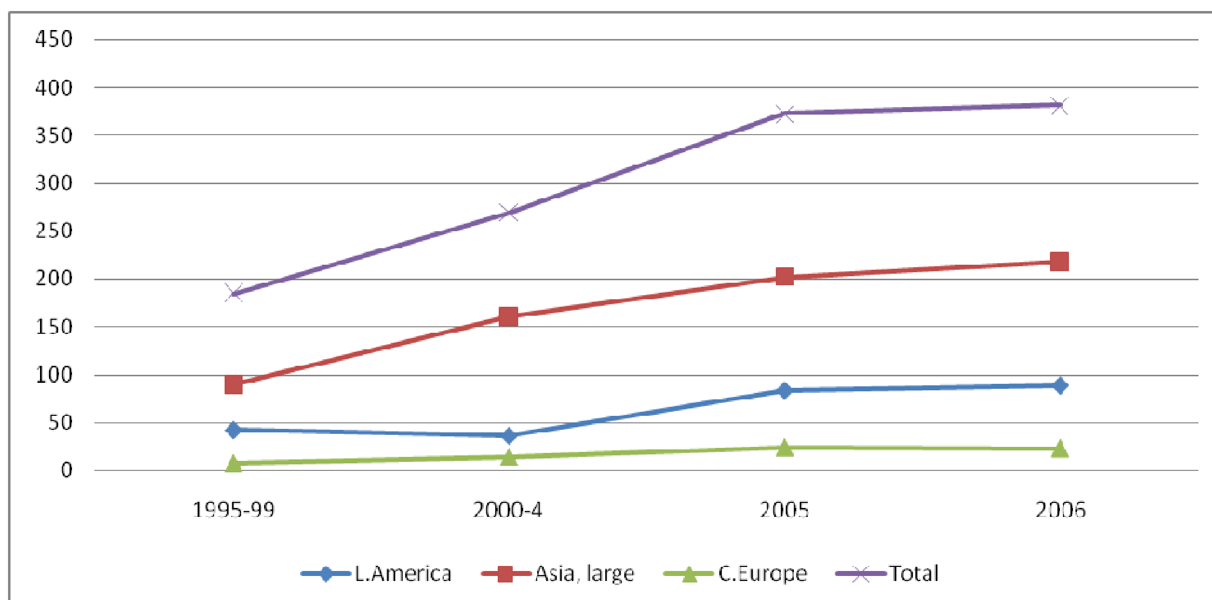
Source: WEO, 2009

Fig. 8. US public debt held by foreign official institutions, % of US GDP



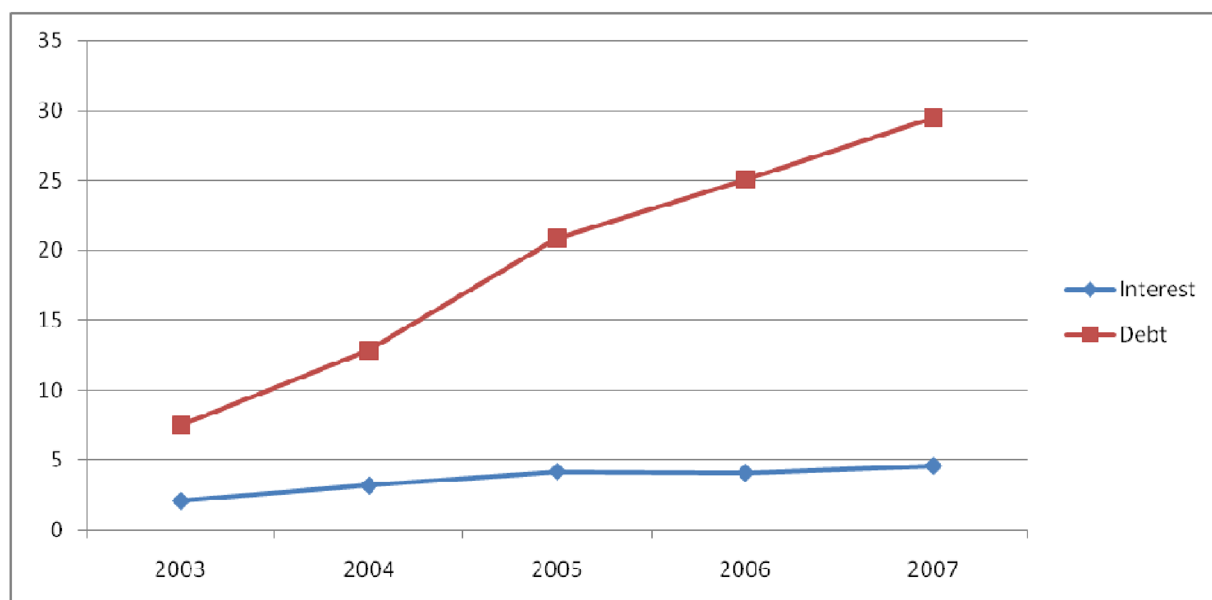
Source: Thomson Datastream

Fig. 9. Changes in stocks of domestic bonds and notes, selected regions, annualised, $bn



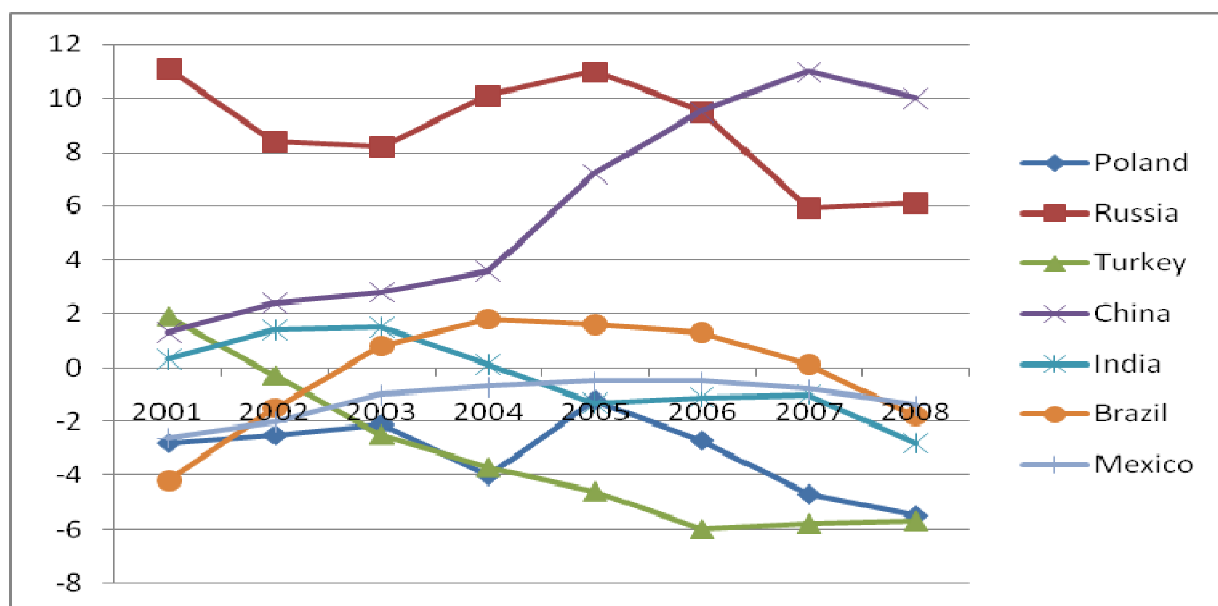
Source: BIS, 2007

Fig. 10. Debt and interest payments, % of household disposable income, Turkey.



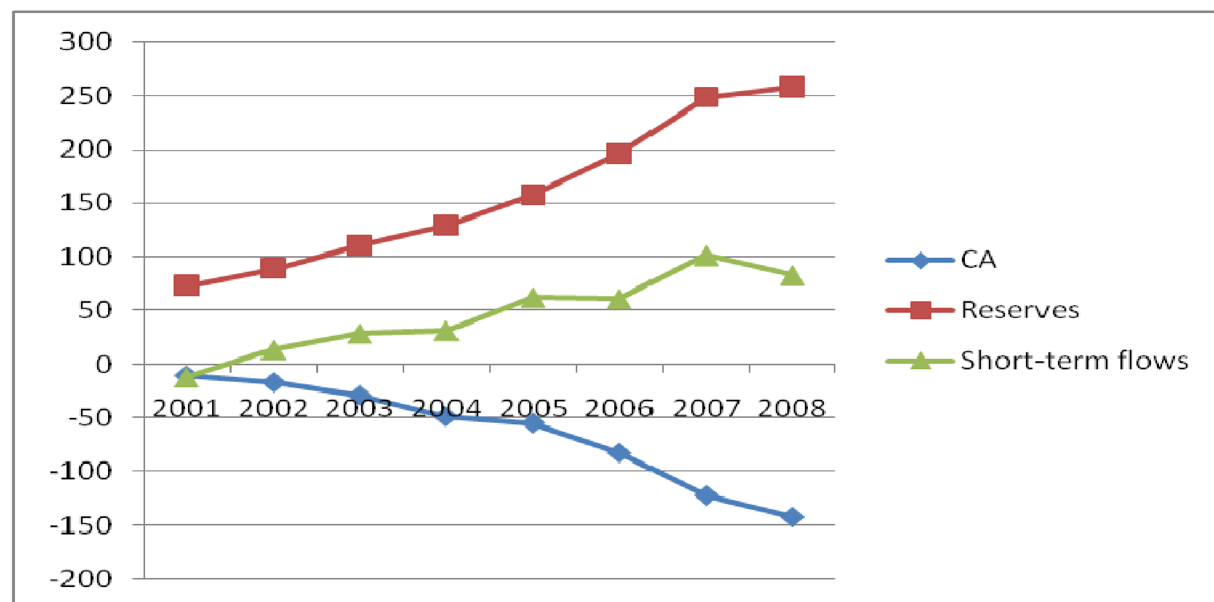
Source: CBRT 2008

Fig. 11. Current account as % of GDP, selected developing countries



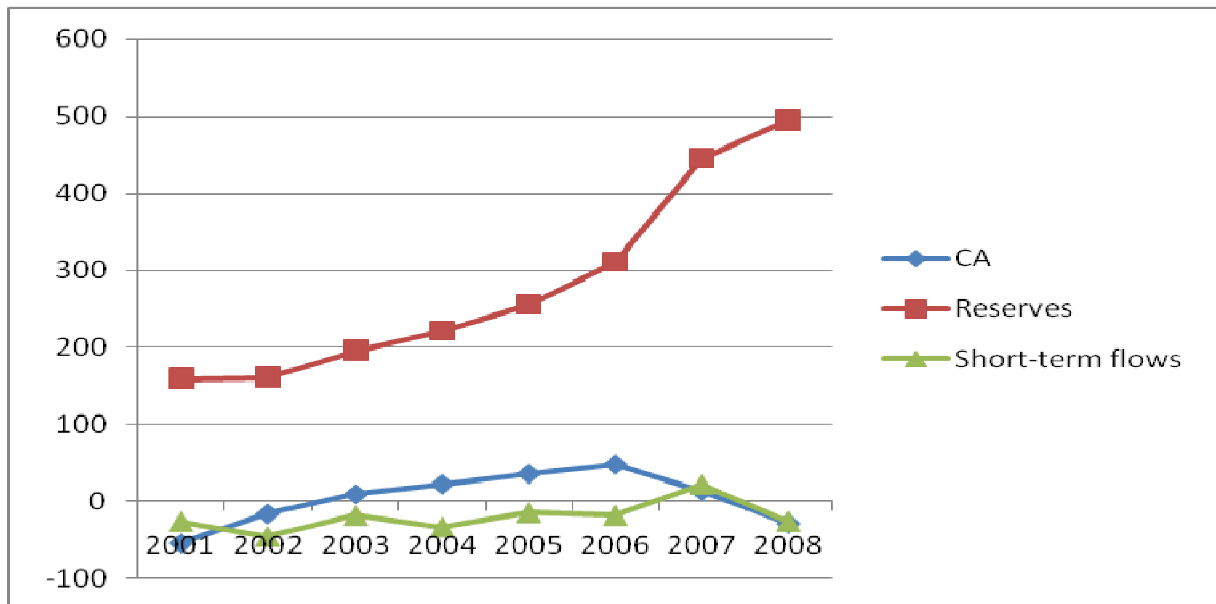
Source: WEO, 2009.

Fig. 12. Current Account, Reserves and Short-term Capital Flows, Central and Eastern Europe, $bn.



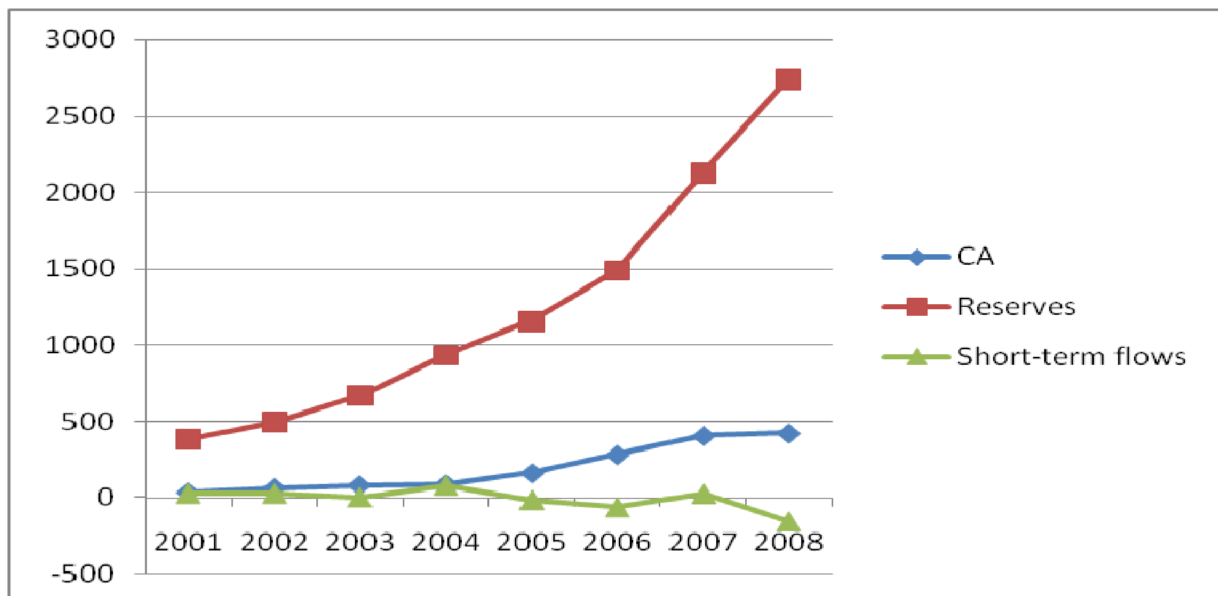
Source: WEO, 2009.

Fig. 13. Current Account, Reserves and Short-term Capital Flows, Western Hemisphere, $bn.



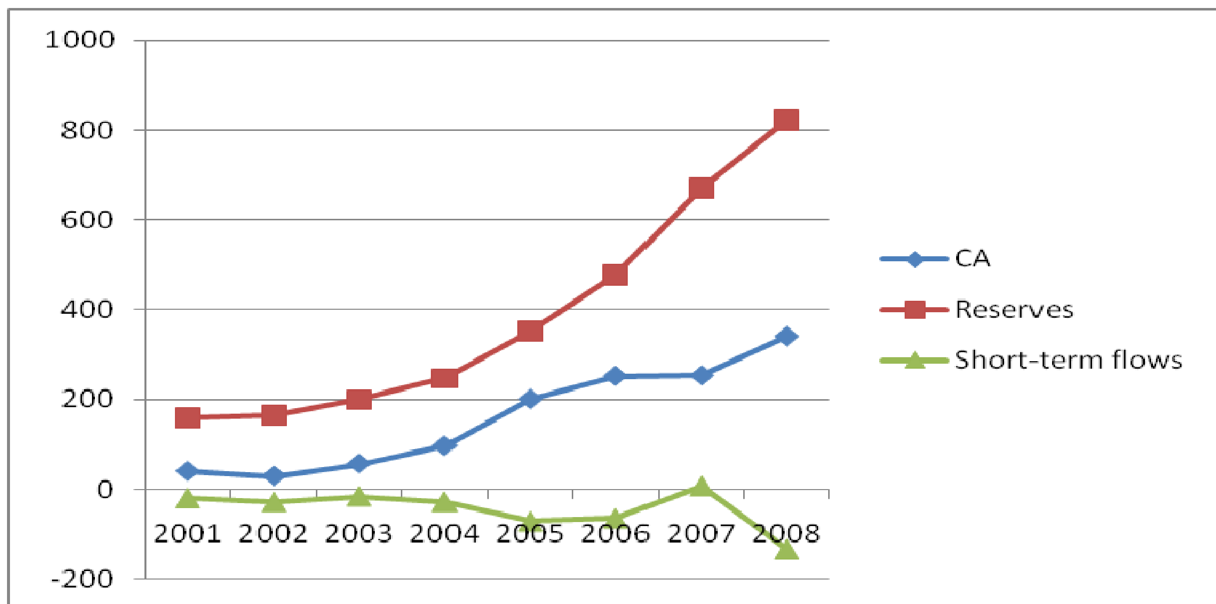
Source: WEO, 2009.

Fig. 14. Current Account, Reserves and Short-term Capital Flows, Emerging Asia, $bn.



Source: WEO, 2009.

Fig. 15. Current Account, Reserves and Short-term Capital Flows, Middle East, $bn.



Source: WEO, 2009.

Table 1. Reserves of emerging and developing countries, $bn

	China	*India*	*Russia*	*Brazil*	*Mexico*	*Sub-Saharan Africa*	*Central and Eastern Europe*
2001	216.3	46.4	33.1	35.6	44.8	35.5	72.8
2002	292	68.2	44.6	37.5	50.6	35.9	89.2
2003	409.2	99.5	73.8	48.9	59	39.8	110.6
2004	615.5	127.2	121.5	52.5	64.1	62.2	129.2
2005	822.5	132.5	176.5	53.3	74.1	82.9	157.9
2006	1069.5	171.3	296.2	85.2	76.3	115.8	196.3
2007	1531.3	267.6	466.7	179.5	87.1	146.3	248.9
2008	2134.5	271.7	421.3	192.9	94.6	163.5	258.6

Source: WEO, IMF, 2009

Table 2. Consumer loans as % of total loans of largest banks, Mexico

Bank	Year before merger	2006
Banamex	6.25 (2000)	35.6
Bancomer/BBVA	3.27 (1999)	23.9
Serfin/Santander	1.18 (1999)	18.3
Bital/HSBC	12.6 (2002)	21.1
Banorte	1.78 (1999)	12.4

Source: Lapavitsas and Dos Santos (2008).