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*SYNTHESIS REPORT D6.10:*

# **THE IMPACT OF FINANCIALISATION ON MAJOR EMERGING ECONOMIES**

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**Summary:** This Synthesis Report covers the material in six FESSUD Working Papers on the effects of financialisation on six major Emerging Economies. These Working Papers include “The Impact of Changes in the Global Financial and Monetary System on India”, “Financial Imbalances in the Global Economy: Consequences for Brazil and Indonesia”, “International and Domestic Financialisation in Middle Income Countries: The Brazilian Experience”, “Financialisation and Development: The South African Case Study”, “Financialisation, Uneven Development and Faltering Governance: The Case of Turkey” and “Assessing China’s Prospects within the Context of Global Imbalances”. The Synthesis Report ends with a summary of the main points in each case study.

**Keywords:** Capital account, international capital flows, financialisation, financial liberalization, net external asset position, foreign direct investment, portfolio investment, international monetary system, foreign exchange reserves, central banking, and global imbalances.

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This Synthesis Report for the FESSUD project is Deliverable 6.10. It synthesizes the results of six Working Papers that have been part of Deliverable 6.07. These Working Papers have covered the major Emerging Economies of Brazil, China, India, Indonesia, South Africa and Turkey. Though there were many illustrative tables and graphs in these Working Papers, we refrain from including them in this Synthesis Report. For more detail, readers can refer to the Working Papers themselves.

The ensuing text does not follow the numbering of the Working Papers. It begins with the Working Paper that sought to evaluate the impact on India of changes in the global financial and monetary system. This basic approach will be emulated in the summary of the other five Working Papers that are part of this Deliverable. At the end, this Synthesis Report will provide a general summary of the main trends and their implications.

## **I. Working Paper #145. “The Impact of Changes in the Global Financial and Monetary System on India” by P. Mukhopadhyay**

### **I. Introduction**

Working Paper #145 (Mukhopadhyay 2016) has focused on the impact of financialisation in India and drawn its results through analysing both an international data set of macroeconomic variables and a country-level dataset for India itself. It also utilizes firm-level data in order to examine the impact of financial liberalisation on firms of different categories.

One of the major points from its analysis of firm-level data suggests that a significant share of the increase in the level of credit to industries over recent years has been used for financial investment and the holding of inventories rather than for productive investment.

The paper also utilizes the CAM global macro model to do medium-term projections for the Indian economy. In this respect, it is similar to the Working Papers that have focused on China (Working Paper #144) and on Brazil and Indonesia (Working Paper #141). The projections for India point to a major policy lesson, namely, that if the country wishes to continue its relatively high rate of economic growth until 2030, it needs to increase aggregate demand both domestically and through an export push.

The main engine of increases in domestic demand would be private investment and support for an export push that would involve real exchange rate devaluation. At the same time, however, the author of this Working Paper warns that opening up India's capital account would very likely lead to a build-up of unstable external portfolio liabilities. This is a concern that this Working Paper shares, in particular, with Working Paper #141 for Brazil and Indonesia.

## II. Trends in India's Economy

The paper starts by presenting a review of trends in the Indian economy from 1970 to 2013. Thereafter it supplements this review with projections generated by the CAM global macro-econometric model for the period between 2015 and 2030.

According to PPP estimates of GDP, India has already emerged as the third largest economy in the world, after China and the USA. But the central concern for Working Paper #145 is whether India can continue growing at a relatively high rate in the future if its economy becomes increasingly 'financialised'. Such a potentially adverse trend would imply, for instance, that India's firms would increasingly rely on investment in the financial sector instead of investment in manufacturing.

The share of external financial assets held by India has remained relatively modest. In 1990 it accounted for only 0.08% of all such assets at the global level. By 2013 this share had risen to only 0.37%. According to current trends, India's share would reach about 1% of the total by 2030.

This modest trend contrasts sharply, for instance, with the trend in China: by 2030 this country would hold 11.6% of all external financial assets. Hence, India is not expected to amass sizeable foreign financial assets, including foreign-exchange reserves, as an effective hedge against the instability of inward foreign financial investment in the country.

Between 1993 and 2004, India experienced current-account surpluses. But since that period, it has suffered from recurrent current-account deficits. Thus, there has been a secular increase in India's net external liabilities as a result of having to finance such deficits.

Within this overall trend, the share of India's total external liabilities that are represented by relatively unstable short-term portfolio liabilities remained around 23% between 1990 and 2013, but it is projected to rise to 31% by 2030. By contrast, China's projected share would remain much lower, namely, at about 8%. So India is likely in the future to remain vulnerable to the instability of global financial forces.

This Working Paper is particularly concerned about the relationship between India's rate of economic growth and the growth of its financial sector. Before 1990 banks in India were generally publicly owned and controlled. But since that time, private banks as well as foreign private banks have been allowed to enter the country's financial sector.

## **Regressions on the Financial Sector and Economic Growth**

One of the central issues for this Working Paper is whether the provision of credit under the current conditions of the Indian banking sector is having a positive effect on economic growth. In order to draw inferences on this connection, the paper runs a number of statistical regressions.

For example, it compares conditions during the pre-reform period, i.e., between 1971 and 1990, with those in the post-reform period since 1990. The relevant question for such regressions is whether the entry of foreign and private banks into India's financial sector has enhanced competition and efficiency, and has thus spurred faster economic growth.

The Working Paper's initial regression results at the state level suggest that the impact of credit on economic growth has indeed been positive and more pronounced in the post-reform period.

The Working Paper also carried out regressions at the state level across the three major sectors of the Indian economy, namely, industry, services and agriculture. While there appears to be a positive relationship between the additional provision of credit and growth in the agricultural and services sectors, in industry there appears to be a negative relationship.

This is a troubling result since industry—and manufacturing in particular—needs to play an increasingly important role in the Indian economy. Moreover, in this regression analysis all of the values of the elasticities of growth with respect to credit were less than one. Namely, the relationships were inelastic: economic growth responded less than proportionately to increases in credit.

Over time there has indeed been a significant growth in credit measured as a ratio to GDP in India. In 1969, for example, this ratio was a mere 1%. But by 2012 it had risen to 88%. Similarly, credit as a percentage of gross capital formation had risen by 2012 to 200%. But this Working Paper argues that a significant share of this credit has been deployed for financial investments and inventory stock-piling instead of for expanding the stock of fixed productive assets. Specifically, financial

investments represent the expenditures of firms on buying assets such as shares, debentures, bonds and mutual funds.

In India banks have remained the chief financiers of firms' investment. In other words, the country has remained a debt-driven economy. But a crucial issue is whether in incurring such debt, firms have invested in physical capital or financial assets.

## **Regressions on Borrowing and Investments**

In examining such issues, this Working Paper carries out regressions on the relationship between borrowing and investment in physical assets. Its results suggest that the resultant mean expenditures on physical investment have been much smaller than the mean expenditures on either financial investment or the holdings of inventories.

These results raise some major concerns. On the one hand, if investment in financial markets is greater than investment in physical assets, this result implies that the rate of return on financial investment is likely to be higher than that for productive investment. Unfortunately, this is a barometer of increased 'financialisation' of an economy and its potentially negative effects would need to be monitored carefully.

On the other hand, if investment in inventories exceeds investment in productive assets, this outcome could be a barometer of 'over-production', leading, in other words, to a piling up of unused inventories. Namely, the *demand* for goods and services across the Indian economy could be adversely affected by financialisation. This phenomenon could be characterised as induced 'under-consumption'.

An additional policy concern is that the current Indian government is making a major effort to limit its fiscal deficit. The current target, for example, is to contain the fiscal deficit within a maximum of -4% of GDP by constraining government expenditures. But if such a policy option is followed over an extended period, the financing of public investment and social expenditures could be adversely affected. This outcome would represent an additional brake on the expansion of aggregate demand.

### III. Macro Modeling of Policy Options for the Indian Economy

The issues above raise important concerns about how India can be expected in the future to continue maintaining relatively high rates of economic growth within the constraining context of 'under-consumption'.

In order to address such concerns, the authors of the Working Paper utilize the CAM global model to test the effects of a more progressive package of policy options over the medium term, i.e., until 2030. The results of such an alternative projection can then be compared to those for the 'baseline' projection, which would continue current demand-retarding government policies.

The alternative policy scenario devised by the authors is based essentially on increasing **domestic demand** and supporting an **export push**. In order to avoid inflationary pressures, however, increases in demand in this scenario are adjusted in order to constrain the growth of GDP to be less than 8%.

Also, the alternative scenario accepts the general thrust of the government's intention to limit its fiscal deficit. This leads to a reduction of the Net Lending of the Government to about -4% of GDP. As a result, there would be secular decline in India's Government debt as a ratio to GDP.

The leading initiative used to boost domestic demand in this scenario is providing incentives to expand private investment. Note that this expansion does not apply to public investment. This macroeconomic programme is also based on allowing a greater degree of foreign investment (relying primarily, it is hoped, on increases in productive Foreign Direct Investment).

One of the major constraints on India's current account is that it is obliged to be a major importer of oil. Hence, in order to support an export push and help contain the country's current account deficit within -2% of GDP, the alternative policy scenario posits depreciation of the real exchange rate along with the promotion of non-carbon energy production. The latter initiative is based in part, for example, on making India's public transport system more environmentally friendly.

This alternative scenario also posits an increase in India's exports of manufactured goods as a necessary foundation for maintaining relatively high rates of economic growth over the medium term. As a result, the share of India's exports of manufactured goods in *total* global exports would rise from 2% to about 3% over the medium term.

#### **IV. Projected Constraints on Future Economic Growth**

India is projected to benefit in the future from the continuance of relatively low oil prices (in contrast to the previous prolonged boom in prices). This future trend should help to contain inflation and constrain the widening of the country's trade deficit. However, as India's income per capita continues to rise over the medium term, there would be a concomitant greater demand for energy.

In addition, the country's projected continued reliance on coal for electricity and petroleum for transport would likely have adverse environmental impacts. Hence, the country will not be able to escape the problem of facing some degree of trade-off between rapid economic growth and promoting environmental sustainability.

This Working Paper's progressive policy scenario would also face other significant constraints over the medium term. There is a projected small drop in public investment, for example, which would certainly have a counter-productive effect. Public investment should be playing, in contrast, a more expansive role as well as helping to stimulate greater private investment.

In addition, the projected greater opening of India's capital account to foreign investment would lead to a sharp increase in short-term unstable inward portfolio investment. For example, as a proportion of total external financial liabilities, portfolio investment would rise from 25% to 32% between 2015 and 2030.

As is shown in the Working Papers on Brazil and Indonesia (to be discussed later), the rise of such inward portfolio investment would increase India's vulnerabilities to the vagaries of international financial flows. For example, the Net External Asset Positions of both Brazil and Indonesia have been decidedly negative, based, unfortunately, on an increasing share of portfolio investment and other short-term financial investment in its total external liabilities.

In 2015 Brazil's Net External Asset Position represented about -50% of GDP and Indonesia's corresponding ratio was more than -60%. While India's Net External Asset Position in 2015 was about +15% of GDP, this ratio would likely turn negative over the projected period based even on the relatively positive projected trends in the alternative policy scenario. Hence, India could face future financial instability.



## **II. Working Paper #141. “Financial Imbalances in the Global Economy: Consequences for Brazil and Indonesia” by R. Jump and T. McKinley**

Working Paper #141 (Jump and McKinley 2016) starts by constructing medium-term projections for global growth and financialisation. Similar to the Working Paper on India, it does so by utilizing the CAM global macro-econometric model. But it first concentrates on examining the trends over 2016-2025 in four major blocs/countries that constitute, together, about 70% of global GDP. These are the USA, Europe, mainland China and the High-Income Region of East Asia (dominated by Japan and the Republic of Korea). Hence, developments in these four blocs/countries are likely to dominate global prospects over the medium term.

### **I. Subdued Growth Along with Current-Account Imbalances**

Even when this Working Paper was first written, namely, in mid-2015, the prospects for global economic growth were subdued. This bleak outcome was projected at that time despite the fact that the model revealed more optimistic GDP growth rates for China (namely, about 7%) than has proven to be the case since mid-2015. The projected growth rates for the other three blocs/countries (USA, Europe and High-Income East Asia) were, at that time, in the lower range of 2-3% over 2016-2025.

Sharp global imbalances in current account surpluses and deficits were expected to worsen, to some degree, over the projected period. China and the High-Income East Asia bloc were projected to maintain, together, current-account surpluses of about 5% of GDP. Meanwhile, the USA's current-account deficit was projected to progressively worsen towards -6% of GDP.

While Europe as a whole would move towards current-account balance—especially since recession in the Southern Periphery of countries (Italy, Spain, Portugal, Greece) has dampened the collective demand for imports—Germany would continue to maintain healthy current surpluses while the United Kingdom would replicate the U.S. trend of a progressively worsening current-account deficit (i.e., reaching around -6% of GDP).

The original CAM projections also suggested that monetary outcomes for the four major blocs/countries over the period 2016-2025 would be at historically low levels. For example, the US real interest rate (on bonds) would continue a historical decline that began in the 1980s and

approach zero by 2025. A similar trend towards zero would characterize the interest-rate projections for High-Income East Asia.

Also, the projections for the inflation rate for the four blocs suggest that it would remain well below 5% across the board. For example, the inflation rate for the USA would decline to below 2% by 2025 and that for Europe would actually end up being negative by 2020—indicating the severe danger of eventual deflation in this bloc.

Hence, on the whole, the projections made in mid-2015 for the four major blocs/countries suggested that economic growth at the global level would remain subdued through 2025. Concomitantly, both inflation and real interest rates would remain historically low.

Also, global imbalances in trade, income and capital flows would remain severe, especially between the USA, on the one hand, and China and High-Income East Asia (Japan and the Republic of Korea), on the other hand. In particular, the current-account deficit of the USA is projected to worsen significantly. But the US deficit (along with a notably worsening deficit in the United Kingdom) would be counter-balanced, to some degree, by continuing current-account surpluses in China and High-Income East Asia.

In fact, the progressive decline in the US current-account deficit would replicate its decline between 1990 and 2006, i.e., just before the outbreak of the global financial crisis. But the earlier experience related to the severe 2008 financial shock warns us that such future trends are also very likely to be unsustainable.

Within the context of the general focus of the Working Paper on the Emerging Economies of Brazil and Indonesia, its projected global trends suggest that if such economies retain fairly open external sectors, they will experience inevitable difficulties in shielding their households and enterprises from re-occurring external financial shocks.

## **II. Capital Accounts and Net Asset Position**

Working Paper #141 provides a more concrete picture of these dangers by decomposing the flows on each country's capital account into four components: i.e., net reserve acquisition, net foreign direct investment, net portfolio investment and the residual of net 'other investment'.

For example, China's capital-account flows would remain modestly negative over the projected period, primarily because it would 'export' sizeable foreign-exchange reserves abroad while it

would receive less substantial net foreign direct investment and net 'other investment' into the country.

In contrast, the USA's capital-account flows would remain substantially positive over the projected period (e.g., approaching 5% of GDP by 2025) because it would enjoy substantial inward flows of short-term speculative portfolio investment and 'other investment' although it would still send, on a net basis, more foreign direct investment abroad than it would receive.

In the US case, the net external asset position would be decidedly negative. By 2025 this asset position, as a percentage of GDP, would reach a -60%. This implies that, on this basis alone, the USA should remain extremely vulnerable to future capital outflows, especially of short-term speculative capital. However, the counter-balancing factor is that the USA would remain the dominant global reserve-currency and financial centre, and thus there would be major disincentives holding back such potential outflows.

By contrast, China would remain in a fairly stable financial position at the global level. While it would enjoy net inward direct investment and 'other investment' (bank lending) by foreigners, some of which could conceivably flow back out of the economy (on an erratic basis), it would still retain an advantage by holding abroad a very large stock of foreign-exchange reserves. Hence, its net foreign asset position is projected to remain at about +40% of GDP by 2025.

After examining trends at the global level (through the lens of the four major blocs/countries), Working Paper #141 turns its focus towards the two major Emerging Economies of Brazil and Indonesia. In some fundamental ways, these two countries share some common characteristics, such as the nature of their current-account balance and their net external asset position. Hence, their economic and financial vulnerabilities could continue to be similar over time.

### **III. Economic and Financial Trends in Brazil**

Brazil suffered in the immediate aftermath of the 2008 global financial crisis. Its currency, the *real*, depreciated against the US dollar by about 60%, financial capital flooded out of its economy and it experienced a sharp economic recession.

In mid-2015, when the Working Paper carried out its initial projections for Brazil, the CAM model suggested that its economic growth would be about -1% in 2015, it would escape from recession in

2017 and its growth rate would reach about 2.5% by 2025. However, ensuing trends, both in Brazil and at the global level, have been more negative since that time.

The earlier projections also suggested that Brazil's current-account deficit, which had been precipitated partly by the collapse in global commodity prices, would again be in surplus by 2019. This turn-around was expected to be driven by a recovery in its exports of primary commodities, including oil.

However, though such a trend looked fairly positive at that time, Brazil's net external asset position told a potentially different story. Post 2015, Brazil was projected to benefit from an increased inflow of foreign investment, including direct investment, portfolio investment and 'other investment'. Speculative capital in particular was expected to flood into Brazil, especially as growth was projected to be subdued, by contrast, in Developed Economies, especially in Europe and Japan.

These trends led to a Brazilian Net External Asset Position that was increasingly negative. This implied that foreigners had invested in many more Brazilian assets than Brazilian had invested in foreign assets. In fact, the only net positive holdings abroad for Brazil (specifically for the government) were foreign-exchange reserves. But such holdings were far outweighed by inward investment in Brazil by foreigners, especially short-term, unstable and highly speculative financial investment.

These trends led to CAM projections that Brazil's Net External Asset Position would turn increasingly negative. By 2021, for instance, this position was projected to plummet to about -52% of GDP and would remain at about -50% in 2025. This kind of financial position implied that Brazil would remain highly vulnerable to external economic and financial shocks. This is, in fact, what began to happen in mid-2015 and intensified during the rest of that year and into early 2016.

Thus, even though the CAM projections suggested that Brazil would regain positive rates of economic growth and enjoy positive current-account balances during 2016-2025, its net global financial position would still progressively worsen—in the sense that it would be highly vulnerable to the periodic outbursts of a large, dramatic and debilitating outflow of speculative financial capital.

#### IV. Economic and Financial Trends in Indonesia

Compared to Brazil, Indonesia had greater success in weathering the 2008 global financial crisis. The chief shock that it confronted was a downturn in its export demand. Despite this shock, the country continued to enjoy a 5% rate of economic growth through 2008 and 2009.

This trend compares very favourably to the country's dire experience during the Asia financial crisis in 1997-98. During that period, finance capital flew out of the country and the Indonesian *rupia* went into free fall, driving up the cost of imports as well as the country's external debt burden. As a result, in 1998 the country's economy shrank by an outlandish -13.7%.

However, despite the fact that the Indonesian economy fared better during 2008-2009 than during the Asia financial crisis in the late 1990s, it has still shared, since that time, some of Brazil's vulnerabilities to external demand shocks, financial turbulence and capital flight. The country's foreign financial liabilities have remained highly liquid since they have been dominated by short-term portfolio investment.

Historically, both consumption expenditures and, to a lesser degree, investment demand have helped to sustain credible rates of economic growth in Indonesia. Government expenditures and the country's trade balance have played a less significant role. Our original CAM projections for 2016-2025 suggest that Indonesia's rate of growth of GDP would average only a little less than 5% per year. This would certainly be an impressive performance.

But the country's trade balance would, in fact, be a drag on economic growth since it would be modestly negative throughout the projected period and would only recover to balance, i.e., 0% of GDP, by 2025. Part of the reason for such a lacklustre trend is that the country's exports would continue to be dominated by primary commodities, especially oil, while its imports would continue to be dominated by manufactures. It is noteworthy that the CAM does not project any dramatic improvement in the global prices of primary commodities from their recent historical troughs.

This combination of problematic trade position and highly liquid and speculative capital inflows heightens the financial risks that the country would continue to confront in the future.

During an earlier period, up through 2005, the bulk of capital inflows into Indonesia were short-term speculative forms of investment (often mainly bank lending). Such flows are customarily

labelled as 'other investment' in order to differentiate them from portfolio investment and direct investment (FDI).

In the build-up to and during the global financial crisis, such short-term speculative capital hurtled out of the Indonesian economy. But well after the financial crisis and especially by 2015, these forms of inward financial investment were again expanding within the country.

However, such a resumption of financial inflows only served to intensify Indonesia's vulnerabilities, especially since its offsetting stockpile of foreign exchange reserves were far too small to be used to counteract the danger of a sudden outflow of such speculative capital.

As a result, during the projected period of 2016-2025, Indonesia's Net External Asset Position is expected to progressively worsen, reaching the nadir of -64% of GDP by 2023-4. This level of financial dependency would exceed even that of Brazil, which even at its projected worst level (in 2022) reached only -52% of GDP.

In summary, Indonesia's real economy is projected to perform fairly well over the period 2016-2025. Private consumption and even investment would help propel economic growth. And the correction of the country's current-account deficit would also contribute to stabilizing economic growth. However, the country would continue to remain highly reliant on the stability of the global prices of primary commodities, including that of oil.

An additional factor that would play a major role in exposing the country to the prospect of recurrent financial instability would be the continuing substantial inflow of short-term financial capital, which would progressively serve to worsen its Net External Asset Position.

In light of our original CAM projections of anaemic global economic growth through 2025 and continuing, if not worsening, global imbalances in current accounts—especially between the USA (and the UK), on the one hand, and China and other East Asian economies, on the other hand—future healthy economic growth as well as financial stability in the major Emerging Economies of Brazil and Indonesia would certainly not be assured.

Combined with their substantially negative Net External Asset Position, Indonesia and Brazil would likely confront and have to mitigate—from a relatively weak economic position—future recurrent bouts of financial instability and ensuing economic crises.

## V. Updated CAM projections

Working Paper #141 was revised in mid-2016 because of the worsening economic conditions at the global level, particularly in major emerging economies. The CAM was aligned with the new forecasts for 2016 by the IMF in its April 2016 *World Economic Outlook* and the model then generated a new set of projections for the period 2017-2026 for both Brazil and Indonesia. This update focused on GDP, investment, the current account and the capital account.

### **Brazil**

The Working Paper covered Brazil first. Because of the realignment with the projections produced by the IMF in mid-2016, the CAM projected that in both 2015 and 2016 GDP growth in Brazil would be -3.8%. However, after 2016 Brazil's growth was projected to recover and stay around 2%-2.5% through 2026. However, such a recovery of growth was not expected to be driven by investment. After falling to about 12% of GDP by 2017, investment was expected recover to only about 13% by 2026.

The CAM's new projections for Brazil's current account are similar to those that it had generated earlier. Due in large part to depreciation of the exchange rate, Brazil's current account as a ratio to GDP would begin recovering from a large deficit in 2016 (i.e., which would be about -5%) and turn modestly positive by 2022. By 2026 this surplus would increase to about 2% of GDP.

The new projected trends in Brazil's capital account position would be quite different from those through 2015. Inward foreign direct investment as a ratio to GDP is projected to essentially collapse, reaching 0% by 2018 and would continue close to zero thereafter.

Portfolio investment would continue flowing into Brazil but would hover around only about 1% of GDP through 2026. In contrast, net 'other investment' would *flow out* of Brazil, reaching 2.4% of GDP by 2026. Brazil's holdings of foreign exchange reserves would rise only marginally over the projected period, reaching just 0.4% of GDP by 2026.

In sum, the net outflows of capital from Brazil would reach about 2.8% of GDP by 2026 while the net inflows would reach only about 1.4%.

Thus, Brazil's capital account is not projected to be in a favourable position: it would receive little FDI, its inward flows of capital would be dominated by volatile portfolio investment, and it would

hold a small stock of foreign exchange reserves with which it could counteract the effects of any precipitous outflow of financial capital.

### ***Indonesia***

The new CAM projections for Indonesia suggest somewhat different outcomes than those for Brazil although both countries would remain subject to some similar economic and financial forces.

By 2017 Indonesia's GDP growth is projected to reach 2%, then increase to about 4% by 2019 and stay roughly at this level through 2026. While Indonesia's investment as a ratio to GDP boomed during the period 2003-2012, reaching the high level of 31%, the CAM projects that investment would decline throughout the projected period of 2017-2026. By 2026 investment would have fallen to 24% of GDP. Still, such a level would far exceed the 13% of GDP that Brazil's investment is projected to reach in 2026.

Indonesia's current account would remain an area of concern. In 2013 the country already had a current-account deficit of -3.7% of GDP and this level recovered modestly to -2.4% of GDP by 2015. But the CAM projects that the country's current-account deficit would then progressively widen to -4.2% by 2026.

In 2014 total financial inflows into Indonesia stood at 2.9% of GDP. But the CAM projects that by 2019 total net financial inflows would decline significantly, reaching a low level of 1.6% of GDP. Thereafter, however, net financial inflows would recover, but reach only 2.3% of GDP by 2026.

What is most significant about these trends, however, is that the net financial inflows into Indonesia would be dominated by increases in net 'other investment' and portfolio investment, the two most unstable forms of capital inflows. In addition, the country would command relatively small stockpiles of foreign exchange reserves with which it could protect its exchange rate from violent, financially induced oscillations.

### **III. Working Paper #146. "International and Domestic Financialisation in Middle Income Countries: The Brazilian Experience" By A. Kaltenbrunner and J.P. Paineira**



## I. Introduction

The distinctive value of Working Paper #146 (Kaltenbrunner and Paineira 2015) is that it closely and thoroughly examines concrete conditions in Brazil as an illustration of the general trend of financialisation that its authors believe is affecting in similar ways what they call 'Emerging Capitalist Economies'. They undertake research on Brazil because they believe that the literature on financialisation has unduly focussed on 'Core Capitalist Economies' and has assumed that the conditions in this group of countries would be similar to those in Emerging Capitalist Economies (ECEs).

The Working Paper's basic argument is that financialisation in ECEs is shaped fundamentally by the integration of these countries into a financialised and structured *international* monetary and financial system and that this form of integration inevitably places ECEs in a subordinated and disadvantaged position.

The Working Paper also points out that while international integration of these countries fundamentally shapes their domestic processes of financialisation, these resultant domestic processes, in turn, exacerbate their subordinated position within the structures of international financialisation.

## II. The International Monetary System and World Money

Working Paper #146 argues that a fundamental characteristic of international financialisation is that it takes place within the *hierarchical structure of the international monetary system*. For example, the monetary conditions in the country with the highest liquidity premium (namely, the USA) will influence monetary conditions across the globe.

In other words, international investors will invariably seek refuge during times of financial instability in the currency of such a dominant country. Hence, this Working Paper argues that 'world money', which serves as the universal means of payment, becomes the inevitable outcome of the evolution of monetary conditions within *global* capitalist markets.

Thus, ECEs as well as other developing economies are obliged to hoard 'world money' in order to effectively participate and compete in international markets for trade and finance. The US dollar is regarded by the authors of this Working Paper as 'quasi' world money. For example, when there is

an increasing international demand for protection against the loss of financial wealth, investors intensify their demand for the US dollar (or dollar-denominated financial assets, as well as gold).

In examining concretely the nature of Brazil's international financial integration and the repercussions on its form of domestic financialisation, this Working Paper focuses on *two major channels of transmission*. The first is the phenomenon of reserve accumulation and the associated financialisation of the country's banks. The second is Brazil's inevitable vulnerability to large and sudden movements of capital and oscillations in the value of its exchange rate. An important point is that these movements can be largely independent of trends in its domestic economic conditions.

### **III. Exchange Rates and Interest Rates**

Since the currencies of ECEs such as Brazil have a lower liquidity preference, they have to offer higher interest rates in order to maintain investor demand for their financial assets. Moreover, because such countries occupy a subordinated position within the international monetary system, they face inevitable difficulties in issuing debt denominated in their own domestic currency.

When ECEs have to offer international investors higher interest rates, such rates invariably depress the country's capacities for promoting domestic investment and economic growth. Moreover, any depreciation of an ECE's exchange rate will increase its external debt burden, and will often be associated with problems of short-term solvency and liquidity. When international investors play such a crucial role in influencing an ECE's interest rates and its exchange rate, the currencies of ECEs will have difficulties in performing normal monetary functions.

### **IV. The Working Definition of 'Financialisation'**

In view of the points discussed above, the authors of this Working Paper prioritise clarifying a working definition of 'financialisation'. They define it as the structural changes in financial relations, practices and needs of the key economic agents of banks, households and non-financial corporations as a result of alternations in real capital accumulation.

The process of financialisation manifests itself in variegated forms: 1) the increased incorporation of households into predatory credit relations (primarily through consumption credits and mortgages); 2) the increased reliance of banks on fees and income from trading (rather than from lending for productive activities); 3) the rise in bank funding from markets rather than deposit taking; and 4) the escalating involvement of large non-financial corporations in financial markets.

## V. Trends of Capital Flows in Brazil

Trends in the external liabilities of Brazil illustrate the country's continuing vulnerabilities to international financial flows. For example, the country's total stock of outstanding short-term (12-month) external financial liabilities stood at US\$ 679 billion (or about 46% of its GDP) in June 2008, just before the outbreak of the global financial crisis. In addition, the country's financial liabilities stood at US\$ 883 billion (or about 40% of its GDP) in March 2011, just before the worsening of the Eurozone crisis.

Moreover, the traditional investors in ECEs such as Brazil, namely, banks and dedicated investment funds, have been joined by a large array of other financial actors—namely, institutional investors (such as pension and insurance funds) and new types of mutual funds (such as exchange-traded funds and macro hedge funds).

Given the enormous size of this current wide array of 'investors', a relatively small reallocation of their portfolio shares can have a huge effect on the capital flows and the economy of an ECE such as Brazil. Moreover, this wide array of investors has very diverse investment strategies, thereby increasing the complexity of foreign investment in the Brazilian economy.

Since these investors have become exposed to an increasingly complex array of domestic currency assets, they have contributed to altering the basic characteristics of Brazil's economic and financial structure. As an indication of the scale of their activities, the value of the participation of such foreign investors in the Brazilian stock market rose from about 25% of the total in 2003 to more than 50% in 2014.

## VI. Amassing Foreign Exchange Reserves

In order to protect itself from financial instability, Brazil (like many other ECEs) has had to amass an increasingly large stockpile of foreign exchange reserves. For instance, in 2004, the country held about US\$ 50 billion of such assets, but by 2014 it was holding US\$ 364 billion.

Working Paper #146 argues that such large reserve accumulation is an inevitable outcome of the international financialisation of ECEs as well as their subordinated insertion into such a system. Independently of their current account position, ECEs have become large recipients of capital inflows. For example, total capital inflows into ECEs ballooned from US\$ 299 billion in 2000 to US\$ 1.1 trillion in 2014.

In response, the central banks of ECEs have been obliged to build up a large 'war-chest' of foreign exchange reserves in order to help protect their economies from sudden stops in such inflows or rapid outflows of such financial capital.

## **VII. Switching from Investment to Consumption**

In addition, central banks have had to respond to such large financial inflows by attempting to 'sterilize' their impact on the domestic economy. They have used 'repurchase agreements' with domestic banks, which have involved transferring domestic public debt securities to banks in order to mop up excessive inflows of financial capital. The purpose has been to drain the excess of bank reserves out of the economy.

But, as the concrete trends in Brazil illustrate, the principal result of such central bank interventions has been, unfortunately, that domestic banks have used such new public assets as a basis to issue more short-term liabilities. These loans have been used mainly for expanding domestic household consumption and housing mortgages. In the process, the economic dynamics of the household sector have become essentially more 'financialised'.

At the same time, domestic banks have ended up holding a larger share of short-term assets and decreasing their long-term lending for the domestic productive sector. So there has been a dramatic switch in credit allocation from what could be considered productive lending to industry towards more short-term lending for household consumption and the financing of housing. When household consumption has stagnated, for example, banks have switched their lending to real estate.

The overall effect of the actions of the central bank in attempting to sterilize the impact of increased inflows of financial capital has only encouraged domestic banks to engage in more short-term lending.

## **VIII. The International Transfer of Resources**

In general, such capital inflows, the increased holding of foreign exchange reserves by the central bank in response and the role of domestic banks in moving towards more short-term domestic lending have contributed to slower growth in ECEs and reinforced their subordinate position within the global financial system.

Brazilian domestic Non-Financial Corporations have also become increasingly enmeshed in speculative ventures. For example, many of them have significantly increased their foreign currency borrowing on offshore markets. But frequently such borrowing, such as in US dollars, can be used to invest back into Brazilian domestic currency assets and thus take advantage of favourable exchange rate movements.

As a general trend, the accumulation of foreign exchange reserves by the governments of countries such as Brazil implies a constant transfer of resources from ECEs and other developing economies to Core Capitalist Economies (CCEs). The foreign exchange reserves that a central bank such as Brazil's holds abroad have a very low rate of return.

At the same time, the inflows of foreign capital into Brazil command a much higher rate of return. Combining this persistent inequality in rates of return with the phenomenon that productive loans to domestic industry are being increasingly supplanted by unproductive household loans helps to clarify that the dynamic of unequal exchange between ECEs and CCEs (such as between Brazil and the USA) is being intensified by the general process of financialisation.

## **IX. Exacerbating Financial Vulnerabilities and Uneven Development**

In addition, in such a global system an ECE such as Brazil remains highly vulnerable to large and sudden outflows of speculative capital and the ensuing depreciation of its exchange rate, both of which could be, in fact, largely extraneous to any significant changes in its domestic economic fundamentals. Even when such financial investment remains within Brazil and is denominated in its domestic currency, the *Real*, it is often concentrated in very short-term, high-yielding and volatile asset classes.

In summary, Working Paper #146 has sought to demonstrate that through various channels, the increased 'financialisation' of an ECE such as Brazil is fundamentally shaped by its subordinated position within the international financial and economic system. Moreover, such a financialisation process serves only to cement this subordination and exacerbate uneven economic development. And it is important to emphasize that this process works both through the functioning of the real economy and the self-reinforcing dynamics within financial markets themselves.

## **IV. Working Paper #142. "Financialisation and Development: The South African Case Study" By G. Isaacs**

## I. Introduction

Working Paper #142 (Isaacs 2015) focused on the impact of financialisation in (post-apartheid) South Africa. It draws its results from analysing South African macroeconomic time-series and firm-level datasets. The macroeconomic data allow for an investigation of broad trends within the economy and the advance of financialisation and its impact. The firm-level data help to interrogate the impact of financialisation on non-financial corporations in particular. This investigation is complemented by other national data – such as on housing markets – as well as international datasets.

The topic of this Working Paper poses a number of challenges since causal relationships, in this case between financialisation and development, are difficult to prove. The case study also spans a vast amount of material exploring the nature of financial liberalisation and development and assessing the resultant impact on growth, patterns of investment and poverty and inequality. The approach adopted is to compare the international evidence regarding the consequences of financialisation with the specific trends observed in the South African context. Though an imperfect exercise, this approach can hopefully be potentially illuminating.

## II. Financialisation and Trends in the South African Economy

South Africa underwent a process of liberalisation and financialisation beginning at the dawn of its democracy (1994) but the roots of this process can be located in preceding policies and transformations.

Key policy transformations accelerated between 1994 and 1996, a period during which: the government returned to international capital markets; the financial Rand was abandoned; restrictions on foreign bank entry and foreign participation on the Johannesburg Stock Exchange (JSE) were lifted; limits on institutional investors' financial trading, locally and abroad, were eased; and FDI requirements were relaxed.

This period was followed later by inflation targeting and further market liberalisation. Subsequently, South Africa has been plagued by: lackluster growth; high levels of poverty, inequality and unemployment; and low levels of real investment—all in the context of a marked financialisation of the economy.

This financialisation is broadly visible in the expansion of the financial sector, which has grown at a rate of 4.7% per year compared with the GDP growth rate of 3.1%. Thus, this sector expanded as a share of GVA from approximately 13% at the end of apartheid (which lasted 1950-1993) to approximately 19% over the next twenty years (1994-2013).

Financial markets have experienced significant expansion, with their market capitalisation to GDP ratio rising from 123% in 1990 to 291% in 2007, alongside strong growth in currency and derivative exchanges. Institutional investors have come to play an important role in the economy while the traditional distinctions between banks, merchant banks, instalment credit houses and building societies have been dissolved.

Non-financial firms have also become subject to the imperatives of financialisation, based on the emergence of a new 'market for corporate control', the prioritisation of a 'shareholder value' orientation and the increasing participation of these firms in financial market activity.

This trend has occurred in tandem with their internationalisation and insertion into already financialised global markets and global value chains. These trends have resulted, in turn, in the importation and imposition of financialised business norms on South African businesses as a whole.

One key consequence of the altered investment patterns (as has been the case elsewhere in the world) has been the steady rise in the acquisition of financial assets along with the concomitant decline in gross capital formation. The examination of such investment patterns forms a central part of this Working Paper's analysis.

Financialisation has also deeply affected households through an expansion of financial services. The last decade has witnessed a resurgence of mortgage financing (though still skewed against the poor) and an expansion of consumer credit together with a marked rise in both the assets and liabilities of households. Housing now accounts for the overall negative net financial position of households.

Together these trends led to a very large real-estate bubble and a consumption boom that are widely recognised to have driven the economic growth of the mid-2000s. These trends have all been fuelled in large part by short-term foreign capital inflows (in contrast to the country's long-term trend of capital outflows).

Domestic financial development, measured often by the ratio of domestic credit to GDP, has accelerated rapidly in South Africa. The international evidence has suggested that there is a turning point at which further financial development is growth-retarding, and this is usually when the credit to GDP ratio reaches between 75% and 100%.

The Working Paper shows that South Africa has already reached this threshold. It also presents ample evidence that financial liberalization—contrary to assertions by its proponents—has not been growth-enhancing.

### III. **Financial Liberalisation and Capital Flows**

South Africa has undergone significant financial liberalisation, with its economy in recent years becoming more financially open than other comparable Emerging Economies. But a large body of evidence shows clearly that financial integration is neither a necessary nor a sufficient condition for rapid economic growth, nor is there a predominant statistically significant relationship between changes in financial openness and economic growth when other major growth determinants are included. This lack of a significant relationship is particularly the case in developing countries.

Negative impacts of financial liberalisation on economic growth and other macroeconomic trends have often been observed and are attributed to the propensity of financial liberalisation to lead to: instability, volatility and crises; sudden reversals of capital flows; inequality; and a dysfunctional allocation of capital both internationally and nationally. South Africa has suffered from many of these negative impacts.

#### ***Volatility***

The Working Paper documents that as the gross stock of foreign assets and liabilities in South Africa has increased, so too has the volatility of capital flows. Volatility is well recognized to have negative economic impacts. The evidence presented in the Working Paper demonstrates that movements in capital flows have been closely associated with the erratic and volatile nature of the South Africa exchange rate, and that this channel has been the main means through which crises have occurred in South Africa.

#### ***Capital Outflows***

South Africa has also suffered since liberalization from significant capital outflows, depleting thereby the funds available for domestic investment. This effect has occurred in a range of ways.



First, capital flight is estimated to have averaged 12% of GDP between 2001 and 2007, peaking at 23% in 2007. Associated with this trend has been the staggering statistic that 37% of all reported South African assets are held abroad (as of December 2014) and are sitting in low-tax jurisdictions. This level represents an increase, in fact, over the 24% reported in December 2001.

Second, South Africa, like much of the developing world, has been acquiring large holdings of foreign exchange reserves, particularly from 2000 onwards. The sterilisation process associated with these reserves and the foregone interest on the alternative investment of these funds heighten vulnerabilities in the domestic economy and deplete domestic resources.

Third, as a result of these trends, increasing dividend and interest payments have been made to shareholders and creditors abroad.

### ***Patterns of Inward Investment***

The nature of foreign investment within South Africa also poses risks to the economy. A growing share of foreign assets and liabilities has been short-term in nature, with a sharp growth in portfolio investment flows. Such flows are subject to rapid reversals, with the potential to pose significant harm to the domestic economy.

These portfolio investment inflows are necessary to finance South Africa's current account (in part due to the capital outflows discussed above) but have to be sustained by high interest rates (relative to those in developed economies). This result can thus dampen domestic investment. The rise in the foreign indebtedness of the South African private sector is also a major cause for concern.

## **IV. The Domestic Allocation of Credit**

Related to the forms that financial flows have assumed is the use to which credit in the domestic economy has been put (whether for productive, consumption or speculative purposes), which markets it has entered (for example, stock or real estate markets), and to whom it has been lent (i.e., to businesses, banks, households or the state).

A significant body of literature is emerging that illustrates that non-productive credit, of which household credit is a large component, is ultimately growth-retarding. Consumption credit, through financing consumption demand, creates high levels of gross indebtedness and does not generate the conditions for its own repayment.

Ultimately, households become indebted beyond their means, and this result heightens the probability of financial instability and crisis, including business failures when credit levels become unsustainable (as seen in the sub-prime crisis of 2007-8).

Since such credit funds are channelled through the financial sector, they heighten the prospect of speculation and the allocation of resources to the financial, and not the productive, sector. This trend has a net negative effect on sustainable, productive and long-term economic growth and development in South Africa.

It must also be noted that over-investment via productive credit can lead to over-capacity and excess supply while the hoarding of funds by enterprises can result in under-investment in the economy at large and ensuing stagnation. The extent and nature of international capital flows have a profound influence on domestic credit allocation, with short-term non-FDI flows (which have been dominant in South Africa) promoting adverse patterns.

There have also been significant changes in the evolution of borrowing and lending in South Africa. Households, which were the largest net savers in the 1970s, became net debtors by the 2000s, and this trend played an important role in driving the overall levels of indebtedness in the economy. The level of debt to GDP increased from below 60% in 1994 to over 85% in 2008. This trend fuelled consumption-led growth in the mid-2000s.

The majority of this debt was for mortgages, but other forms of consumption credit have also risen, particularly for low-income households. For example, short-term consumption debt, via credit card debt, store cards and unsecured lending, has risen steeply, as has the number of impaired loans, indicating the unsustainability of such lending.

The Working Paper also documents that debt expansion in South Africa from 2002 onwards has been supported predominantly by the foreign sector and that this tendency has been particularly true of the consumption-led boom of 2002/3 to 2006/7. This trend of debt expansion has been indicative of how the foreign sector has fuelled credit expansion and how that effect has decreased savings in the domestic economy. Moreover, the ensuing effects have also tremendously buoyed real-estate prices and stock-market capitalisation and trading.

Finally, between 2009 and 2011 the private corporate sector in South Africa became a net supplier of credit, with net credit/debt supply/acquisition close to zero in subsequent years. This has

provided evidence of the over-capitalisation of non-financial corporations (NFCs) and their reserves of cash savings. Despite this impact, corporations have still taken on large amounts of debt, often channelled towards unproductive purposes, a topic to which this summary will now turn.

## V. Domestic Patterns of Investment

Crucial to the process of financialisation in South Africa are the patterns of domestic investment. In the name of 'shareholder value maximisation' and as a result of South African corporates becoming more deeply intertwined with financial markets, funds have been drawn away from real fixed investment in the productive sectors of the economy.

The precipitous rise in institutional investors – which have more than doubled their assets as a share of GDP since 1990 – has contributed towards a 'market for corporate control' and has thus exacerbated short-termism and prioritising narrow financial-market metrics of success. Such trends have been shown elsewhere in the world to have undermined real fixed investment and growth, and have been associated with casualisation of labour, downsizing and outsourcing.

The above phenomena can be observed in the growth of the 'rentier share' for non-financial corporations in South Africa. The related pressures are clear in the growth in the pay-outs of dividends and interest and in the use of share buybacks by the non-financial corporate sector.

As a result, there has been a rise in both investment income and dividend pay-outs as a share of operating profits for non-financial corporations, together with a decline in gross fixed capital formation (as a percentage of GDP) as well as a decline in the growth rate of fixed capital stock.

On the macroeconomic level, the financialised business environment in South Africa has been characterised by the volatility of financial markets and hence a high degree of uncertainty, making large physical investments less attractive.

Capital-market liberalisation – which has increased uncertainty, raised real interest rates and exacerbated exchange-rate and capital-flow volatility – has combined with a lack of availability of long-term credit to intensify competition in goods markets. Also, the presence of high returns in financial markets has precipitated altered investment decisions by non-financial corporations. These effects have resulted in an aggregate reduction in productive investment.

These results help pull together the various elements discussed in the Working Paper. They demonstrate that the imperatives of financialisation tend to reduce aggregate fixed investment and that this adverse effect must be compensated for in order to maintain aggregate demand and profitability.

Credit-fuelled spending is thus a crucial response, supported by asset bubbles against which funds can be borrowed. In the short run, profitability can also be maintained by financial market speculation, which has become increasingly linked with the expansion of credit in the form of a dizzying array of financial assets that are further and further removed from aiding the productive capacity of the economy.

These trends are apparent in South Africa. But they exhibit unique features, one of which is the exclusion of the poorest from financial markets. This perverse system has not come crashing down, in part because South African banks have not engaged in a similar scope of speculative investment as banks in the US have. But a slow-burn crisis is still underway, with a real-investment strike by businesses at its heart. The final topic of this Working Paper is the impact of financialisation on distribution.

## **VI. Poverty and Inequality**

At the global level, there is a close correlation between rising financialisation and increasing inequality, with resultant negative effects on poverty. This trend is due to general instability and poor economic growth, the diversion of funds away from employment-generating productive investment, the concomitant adverse transformation of work, the decline in labour's bargaining power and the prioritisation of shareholder value maximisation.

The Working Paper documents that in South Africa this phenomenon has been observable in the falling wage share and increasing income inequality. There has also been a very uneven distribution of financial wealth, all of which has been compounded by rising unemployment and a fall in the share of employment in the manufacturing sector.

In conclusion, the Working Paper illustrates the robust nature of financialisation in South Africa and how it has accelerated financial development and liberalisation, driving patterns of capital flows and domestic credit allocation and altering trends in domestic investment and distribution.

Together, these effects have constituted a toxic mix, which has had significantly deleterious effects on South African economic growth and development.

## **V. Working Paper #143. "Financialisation, Uneven Development and Faltering Governance: The Case of Turkey" By Z. Aydun, M. Byurburg, O. Bedirhanoglu et al.**

### **I. Introduction**

Working Paper #143 (Aydun et al. 2016) shows that Turkey is a country where the need for economic adjustment has emerged periodically since the end of the Second World War. Indeed, there have been stabilisation programmes for more than two decades in response to balance of payment difficulties that the country has encountered while pursuing a strategy of industrial development, whether planned or otherwise.

But with the launching of the January 1980 stabilisation programme, there was an acknowledgement in the international financial community as well as in domestic political and business circles that a qualitatively different programme should be proposed. Indeed, the country initiated an ambitious programme of structural adjustment even before such a strategy was formally spelled out by the Bretton Woods institutions.

This programme signified a radical change since the establishment of the Turkish Republic *both* in the mode of articulation of the Turkish economy with the world economy and in the role that the state played in conducting economic policy. One of the striking changes of the 1980s was that Turkey's integration with the world economy gained a new salience as an end in itself, at least at the level of economic and political discourse.

Along with this change there was an official denunciation of Import Substitution Industrialisation (ISI) as the source of the country's balance-of-payment difficulties and macroeconomic instabilities. Thus, this change paved the way for the adoption of an export-oriented trade and development strategy based on a more market-directed system of resource allocation. Most importantly, this change would set the stage for a prolonged process of financial liberalisation that would entail a series of major ramifications for the Turkish financial and economic system.

No less importantly, Turkey's ensuing process of integration with the world economy would

entrench international finance capital as the prevailing determinant of the developmental trajectory of its economy. In addition, the Bretton Woods institutions would become major determinants of the country's policy-making process. Thus Turkey's experience has led to a process whereby the key 'policymakers' (the decisive sources of policy ideas, design and implementation) are outside the country.

As an important part of this process, Turkey adopted capital-account liberalization in 1989. The ensuing sudden stops and reversals of capital inflows led thereafter to two deep crises, the first in 1994 and the second in 2001.

These crises were followed later by a deep recession in 2009. In effect, Turkey has become trapped in foreign-debt dominated current-account deficits and a volatile growth environment subject to the vagaries of international finance capital. Though the reversal of short-term speculative capital inflows is often associated with deterioration of the macroeconomic fundamentals of a country, it is often not recognized that such a reversal frequently results from the effects of the capital inflows themselves on domestic macroeconomic conditions.

In the early years of the 21<sup>st</sup> century the most striking aspects of Turkey's political economy have been the persistence of open unemployment and price inflation under conditions of a crisis-prone economic structure; long-standing and rapidly expanding external deficits; and the marginalization of the labor force along with the dramatic deterioration of the economic conditions of the working poor.

## **II. The Role of EU Candidacy in Redefining Turkey's Development Paradigm**

The modes of integration of the Turkish economy with the global economy in the 2000s were shaped by a variety of interrelated international and domestic dynamics. In fact, the last month of the year 1999 could be considered as an important landmark in this process since it witnessed not only the granting of candidate status to Turkey by the EU's Helsinki European Council but also the approval of a three-year stand-by agreement with the IMF.

Yet within less than a year, while the coalition government in power had been diligently implementing the IMF stand-by agreement, the Turkish economy had undergone a typical case of "twin crises", in which a balance of payments crisis took place simultaneously with a crisis of its

banking sector. However, the response to these twin crises was the adoption of the country's "Programme towards a Strong Economy", which was based on two new stand-by agreements with the IMF in 2001 and 2002 that would re-affirm the government's determination to doggedly persist with its structural reforms.

This policy direction led to a historical process that was shaped by a double external anchor, namely simultaneous IMF and EU discipline. Namely, the process of Turkey's 'Europeanisation' assumed the role of the 'whip of external necessity', as the EU Commission's *Accession Partnership for Turkey* coincided with the implementation of the structural reform programmes imposed by the IMF and the World Bank.

No less significantly, the IMF had no inhibition in putting into effect yet another three-year stand-by agreement in early 2005 even when there was neither a balance-of-payment nor a banking crisis on the horizon. The justification given for this agreement was that Turkey remained vulnerable to 'swings in international investor sentiment towards emerging markets' despite having implemented a series of 'structural reforms' under IMF and World Bank guidance.

Critics have claimed that there has been an 'identification of the public interest with the interests of the financial sector' by the advocates of this policy agenda, which has been designed to facilitate the role of financialisation in 'minimising the impact of crises upon the economy' as well as achieving 'the socialisation of the losses of the financial sector'.

In the context of its EU pre-accession, Turkey continued to benefit from EU financial assistance. The Instrument for Pre-Accession (IPA)—which was created as a single instrument to consolidate the mechanisms of EU financial assistance to candidate and potential candidate countries—started being implemented in Turkey's 2007-2013 budget period. The IPA allocated 4.8 billion euros to support the country at that time.

However, the relatively positive relations between Turkey and the EU had already started to become tense in 2004-2005, especially at the political level. The accession of Turkey to the EU turned into a lengthy "open-ended" process, which was perceived by Turkey as a form of discrimination, especially compared to the experience of other accession countries covered by the same Copenhagen Criteria.

In the wake of the protracted crisis of 2008-2009, which soon took the form of a crisis of the entire

Eurozone, the European Commission proposed to implement the “Positive Agenda” in its 2011-2012 Enlargement Strategy Document in order supposedly to bring “fresh dynamics and a new momentum” to the Turkey-EU relations.

In addition to this Positive Agenda initiative, an important factor in recent years in determining the Turkey-EU relationship has been Turkey’s call to upgrade, deepen and modernize the Customs Union. In May 2015, for example, the European Commission and Turkey announced the initiation of procedures to modernize and extend the Customs Union in a way that could enhance and “boost” EU-Turkey bilateral trade and commercial relations—supposedly not as an alternative route but as a complementary initiative to the accession negotiations of Turkey.

### **III. The Implications of Financialisation for Redefining Turkey’s Development Policies**

In the wake of Turkey’s 2001 crisis, the country’s macroeconomic trajectory was shaped in line with the *post-Washington Consensus*. In a nutshell, the earlier motto of “*get the prices right*” was replaced by the new motto “*get the institutions right*”. This new policy direction led to a broad consensus on a ‘*great moderation*’ approach implemented through inflation-targeting central banking, fiscal discipline, fully flexible and freely floating exchange rates and open capital accounts, along with a renewed emphasis on privatization and reduced regulation of the labor market.

A closer look at the impact of financialisation on the Turkish economy reveals the characteristic features of a ‘debt-led growth regime’. Since the 2001 crisis, Turkey’s current account balance has always been in deficit, and the size of its deficits has grown in absolute terms. There have been two major reasons for this pattern: (1) Turkey’s major trade partner, the European Union, has also experienced recession; and (2) the Turkish economy’s dependence on foreign capital has intensified.

While the foreign inflow of capital into Turkey averaged only about US\$ 4 billion per year in the 1990s, it jumped to US\$ 30 billion during the period 2002-2007. In the process, Turkey’s economy became increasingly reliant on a persistent inflow of finance capital.

A disproportionate proportion of the influx of finance capital has been associated with a widening current-account deficit so that there has been a correspondingly necessary rise in the country’s



accumulation of foreign-exchange reserves. But, at the same time, the persistently large financial inflows have driven up the price of domestic stocks and real estate.

Concomitantly, Turkey has suffered from a low rate of domestic savings, which has only served to heighten its reliance on foreign capital. This low rate of domestic savings has corresponded with robust consumption spending, often associated with a rising demand for imported durable goods, thereby worsening the current account.

The Turkish economy since the 2000s has thus represented a typical case of a foreign-capital dependent country, with an appreciated currency, steadily deteriorating current account deficits, relatively cheap foreign credits along with relatively high real interest rates, a relatively low inflation rate, and a resultant process of de-industrialization (because industrial capital cannot compete with cheap imported goods).

As a result, the country's rate of economic growth, especially in the 2000s, has depended on domestic consumption-driven spending. And its persistent current account deficit has corresponded with the accumulation of large financial liabilities vis-à-vis the rest of the world.

The increase in global liquidity, first through massive increases in trade imbalances and second through expansionary monetary policies in the advanced economies, has contributed to Turkey's financial imbalances. During this process Turkey has imported large quantities of energy, intermediate inputs and capital goods while it has exported, to a large extent, low value added products.

The competitiveness of its exports has been supported mostly by relatively low labor costs. Second, foreign capital inflows, due to the increase of global liquidity over the 2000s, have led to the appreciation of Turkey's currency, which has created an additional burden on its export competitiveness while serving to increase its imports.

#### **IV. Turkey's Foreign and Domestic Debt**

The predictable outcome of ever-growing current account deficits can be traced through the evolution of Turkey's external debt. It is noteworthy that unlike in previous decades, private-sector debt, both financial and nonfinancial, started to eclipse public-sector debt by the mid-2000s. But there were no serious attempts by Turkey's policymakers to address this problem.

This reluctance was due to the belief that capital inflows helped spur economic growth and that they were influential in reducing inflationary pressures through the ensuing appreciation of the Turkish lira. The Turkish economy has not been a unique example of this pattern since the frantic global search for yield has led to high levels of capital inflows into Emerging Economies.

In contrast to the traditional stabilization policies that aimed to achieve devaluation as a basis to restrain domestic demand, the new macroeconomic orthodoxy sought to maintain high interest rates in order to continue attracting speculative foreign capital from international financial markets. As a result, Turkey has become trapped in a foreign-debt dominated current-account deficit and a speculative, volatile growth environment subjected to the vagaries of international finance capital.

Economic growth has suffered accordingly. In fact, the average annual rate of growth of Turkey's economy during its previous historical period of import-substituting industrialization, namely, 1962-1979, was 6.5%. But its average rate of economic growth during 1980-2011 was only 4.3%.

Prior to the 2001 crisis, Turkey's government was running sizeable fiscal deficits (while the private sector was running large financial surpluses). These public deficits were often -5% to -10% of GDP. But in the 2000s the government began to aggressively cut public spending, privatize its enterprises and introduce new taxes. As a result, it began to run primary surpluses. Along with credible rates of economic growth, the fiscal restraint of the Turkish government was lauded internationally.

Even though Turkey's total external debt continued to increase in the 2000s and the 2010s, the government's external debt as a percentage of GDP declined. This development has not been a unique phenomenon. In fact, many developing countries in Latin America experienced similar trends over the same period.

Factors such as the positive difference between the growth rate and the real interest rate, large budgetary primary surpluses, and the appreciation of domestic currencies against the US dollar have all contributed to these effects. However, these same factors have also carried a destructive potential since they often then lead to sudden periodic capital outflows and sharp depreciation of a country's currency.

While government debt as a percentage of GDP has been in decline since 2001, private-sector debt

has been on the rise. As the government's financial balance has improved, its indebtedness has declined. But the debt stock of non-financial corporations and households has increased. Based on these developments, the pattern of economic development in the 2000s and the 2010s has been dependent on the domestic private sectors' ability to borrow, especially from abroad.

As interest rates declined in the financial centres of developed economies, such as in the USA and Europe, Turkey's banks relied more on a strategy of borrowing in foreign currency and lending in domestic markets. This process has been accelerated by quantitative easing in developed economies.

Moreover, non-financial corporations in Turkey also began to borrow abroad, by issuing foreign-currency denominated bonds, but mostly they relied on borrowing through bank loans. Such a process has also served to intensify the financial fragility of the Turkish economy since the ability of the government to contain such private debt is limited.

A summary of Turkey's financial accounts provides further confirmation of the differences in financial assets, liabilities and net worth across the major categories of the economy, namely, the general government, the non-financial corporate sector, the financial sector and the household sector.

During the period 2009-2013, for example, non-financial corporations in Turkey had the lowest financial net worth, e.g., between -90% and -120% of GDP. In contrast, the net worth of financial corporations hovered around 0%. The financial net worth of the general government slowly improved, rising from about -21% of GDP to -15.6%.

The financial net worth of households remained the most positive of any domestic categories though it declined slightly—namely, from about 29% of GDP to about 23.5%. The most worrying trend has been the steady increase in household borrowing. It increased from 3% of GDP in 2003 to 21% in 2012.

In fact, the positive net worth of the household sector is likely due to the increased holdings of the wealthiest 10% of households. Their share of wealth increased, for example, from 67% of the total in 2000 to 78% in 2014. Thus, according to available comparative data on wealth holdings, Turkey has very high wealth inequality.

Not surprisingly, the net worth of the Rest of the World vis-à-vis Turkey remained decidedly

positive during 2009-2013, rising, in fact, from about 44% of Turkey's GDP to over 55%.

## V. The Dynamics of Central Banking in Turkey

The effectiveness of the monetary policies of the Central Bank of the Republic of Turkey (CBRT) has become increasingly limited since 2001 as the economy has become more 'financialised'. For example, financial flows into and out of Turkey have been determined primarily by the global appetite for risk instead of domestic economic conditions. Thus, financial flows have tended to be beyond the control of domestic monetary policies.

Between 2001 and 2006 the CBRT adopted inflation targeting policies and was largely able to meet its targets. Thus, it was successful in increasing its credibility. But as international financial flows became larger and more erratic, the CBRT, like other central banks in major emerging economies, became less effective in its efforts to manage monetary conditions.

Such large financial flows had largely stemmed from the unconventional monetary policies of advanced countries, which had begun to pump greater liquidity into their financial markets. This trend triggered increased capital flows to developing countries in a frantic search for higher yields. Such a significant influx of financing tended to appreciate the exchange rates of developing countries. Initially, appreciation of the Lira helped the central bank of Turkey to get close to its inflation targets.

But this appreciation tended to exacerbate Turkey's current account, which was already facing sizeable deficits. Even though its current account did improve as a result of the 2008 global financial crisis, its deficit widened again after 2010. In fact, the performance of the Turkish economy on this front has been one of the worst among comparable countries.

Turkey's rising current account deficits have had to be financed by a massive influx of financial capital. In fact, between 2010 and 2014, the country had to attract capital inflows that were equivalent to about 8% of its GDP. The CBRT benefitted to a minor degree because it could divert such inflows into amassing foreign exchange reserves.

However, because the country was still shouldering a huge burden of foreign debt (largely incurred by the private sector), the ratio of Turkey's reserves to its external debt remained relatively low. Moreover, the ratio of the country's short-term financial inflows to its long-term financial inflows increased after 2010, thereby heightening its financial instability. For example, the share of net

foreign direct investment in total financial inflows declined from about 30% during the period 2002-2008 to only 15% during 2010-2014.

Moreover, the Turkish Lira has become extremely volatile in response to the vagaries of short-term financial inflows and outflows. In fact, between 2002 and 2014, Turkey is reported to have had one of the most volatile currencies among comparable emerging economies.

Such externally driven volatility has hampered the efforts of Turkey's central bank to stabilize the economy. For example, while the CBRT has sought to contain credit growth, such as seeking to maintain it within a 15% growth target, it has largely been ineffective in doing so. The principal reason is that bank credit to the private sector in Turkey has mainly followed the patterns of net capital flows, which have largely followed a boom and bust cycle.

In the era of financialisation, capital flows into major emerging economies such as Turkey are largely determined by global risk appetite rather than domestic economic trends. And such risk appetite is often correlated with factors such as the interest rate policies of developed-country central banks, such as the Federal Reserve. Thus, central banks in Turkey and other major emerging economies and developing countries more broadly are largely obliged to align their policy interest rates with those of the Federal Reserve or the ECB. As a result, they have very limited practical independence in their monetary policies.

## **VI. The Impact on Financialisation on Sectoral Growth and Labour Conditions**

The economic and financial trends outlined above have had a crucial impact on Turkey's manufacturing sector. This sector had been developing medium-tech manufacturing from the mid-1990s until the global financial crisis, and machinery and motor-vehicles sectors played the leading role in that transformation. Over this same period, the textile and clothing sectors rapidly lost their shares in Turkey's total output and employment.

However, the 2008 financial crisis contributed to reversing these sectoral trends. The machinery and motor-vehicles industries experienced a decline in their shares of total output and employment after 2009 whereas the textile and clothing sectors out-performed all other sectors.

These changes show that the march of Turkish manufacturing towards expanding medium-

technology sectors and their accompanying integration into global production chains have been very sensitive to what happens in the country's export markets (and in the case of motor vehicles, specifically to what happens in the European markets). Moreover, these sectors do not have export positions that are stable enough to protect themselves from the fluctuations in the world economy.

The most productive sectors of manufacturing in Turkey are chemicals and engineering, whereas the least productive are textiles and clothing. Therefore, the shift that occurred after the 2008 financial crisis from chemicals and engineering sectors towards textiles and clothing has led to a decline in average productivity in Turkey's manufacturing. In other words, the 2008 crisis has intensified pressures on manufacturing wages because cost competitiveness achieved on the basis of depressing wages appears to have become the most effective short-term strategy for Turkish manufacturing.

When the evolution of labour processes is examined within this global environment, it is understandable why one of the first policies of the AKP (the Justice and Development Party) government was to provide a legal and institutional basis for flexible *labour markets*.

In its first year in office, 2003, the AKP government enacted, for example, a new Labour Law that promoted a new institutional structure. From the AKP government's perspective, two objectives motivated the adoption of this new Law: 1) to bring more flexibility to the labour market and 2) to simultaneously enhance Turkey's ability to implement in this field the relevant EU *acquis* (the body of common rights and obligations binding on EU member states).

In this regard, the most significant characteristic of the Law was the introduction of the provisions on non-standard, atypical, flexible forms of employment, which were intended to be introduced mostly in line with the relevant EU legislation. In addition to favouring more flexible forms of employment, the Law also introduced more flexibility regarding the duration and organisation of working time.

The enactment of the Law was the first step in introducing the new labour regime of the AKP government. Throughout the 2000s, as a part of the government's supply-side economic strategy, there was an increasing use of labour market policies that were shaped by the European concepts of adaptability and employability. This change involved, in effect, shifting the burden of being

unemployed onto the employees rather than considering unemployment as a result of the structural problems embedded in labour markets.

The post-2001 crisis adjustments in Turkey came at a very unique conjuncture of the global economy. First of all, while economic growth was rapid, it exhibited peculiar characteristics. As already outlined, growth was driven mainly by a massive inflow of foreign finance capital into Turkey, which was lured by relatively high domestic rates of interest. Hence, such inflows were primarily speculative in nature.

But an important additional characteristic of the post-2001 era in Turkey—which has often been ignored—has been its *poor job creation* pattern. Credible rates of economic growth have been accompanied by high rates of unemployment and low participation rates in the labor market. For example, the rate of total unemployment rose to above 10% during 2002-2014 compared to its average during 1987-2001 of about 8%.

This is an additional indictment of the accommodation to financialisation and the adoption of the correspondingly conducive economic and financial policies of successive Turkish governments.

## **VII. Working Paper #144. “Assessing China’s Prospects within the Context of Global Imbalances”**

**By T. McKinley**

Working Paper #144 (McKinley 2016) begins by focussing on the future economic and financial trends of the People’s Republic of China within the currently projected global context of slow economic growth and sizeable current-account imbalances. It then contrasts these projections with those generated by an alternative policy-generated scenario in which global imbalances in economic growth and current-account balances would be moderated.

As the IMF has noted in its 2015-2016 *World Economic Outlooks*, global economic growth has noticeably slowed. Between October 2015 and July 2016, for example, the IMF’s periodic projections lowered such growth from 3.6% to 3.1%. But over the same period, there have been persistent disparities in current-account balances across the globe. While China and East Asian High-Income Countries (such as Japan) have maintained large current-account surpluses, other large economies, such as the USA and the United Kingdom, have suffered from large current-account deficits.

Correspondingly, financial imbalances have also become an increasingly serious problem at the global level. The USA has had, for example, a large positive net external asset position while other sizeable economies, such as Brazil and Indonesia, have suffered from having a large negative net external asset position.

But most importantly, as indicated in Working Paper #141 (Kaltenbrunner and Paineira 2015), countries such as Brazil have remained exposed to the vagaries of inherently unstable capital inflows, such as portfolio investment and net 'other investment'. Portfolio investment usually refers to the purchases of shares and bonds. Net 'other investment' is a residual category that is dominated by flows of capital provided as loans or deposited into bank accounts.

These two 'inward' flows of investment into a country's economy are inherently unstable, since they would tend to quickly exit at the first hint of domestic economic problems. Hence, it is not merely a question of whether a country relies on an inward flow of investment capital, but also whether such an inward flow could easily change into a precipitous outflow. So the composition of such investment is also of paramount importance.

## **I. Baseline Projections of Economic Growth and Current-Account Balances**

Working Paper #144 initiates its analysis of China by providing a Baseline Projection of future trends in GDP growth and current-account balances of major countries (including the USA and China) and blocs of countries (such as the EU). This projection assumes no important changes in policy and generates outcomes for the period 2017-2026. These projections are generated by the CAM global macro-econometric model. This is the same macro model that was used for Working Paper #141, "Financial Imbalances in the Global Economy: Consequences for Brazil and Indonesia".

### **GDP Growth**

These projections suggest that China's economic growth would slow to an average of 6.5% over the ten-year period to 2026. This would be somewhat slower than its average rate of 7.1% recorded during 2012-2016, but the projected rate would still be relatively high. In contrast, the projection for GDP growth for the USA indicates that its economy would slow to the fairly low rate of 1.2%-1.3% over 2017-2026.



Economic growth in the European Union is also projected to be low, i.e., 1.2%, while growth in the important global bloc of East Asia High Income countries (mainly Japan and the Republic of Korea) would rise noticeably to 2.3%-2.4%. Mainly because of trends in China and the rest of East Asia, global economic growth would edge up to 2.5% by 2022-2026, the period towards the end of the model's projection.

## **Current-Account Balances**

The CAM projections for current-account balances across the globe suggest that there would continue to be large potentially destabilising disparities. China's current-account surplus as a ratio to GDP would edge downward but would still be almost 4% by 2026. And in East Asian High-Income Countries, the corresponding surplus would be 2.4%.

In contrast, the current-account deficit of the USA would widen from -3.2% of GDP in 2016 to -4.8% by 2026. While the EU as a whole is projected to have a small surplus, namely, 0.8% of GDP, by 2026, a disaggregated picture would be more worrying. For instance, Germany would produce a surplus of almost 5% of GDP while, in contrast, the United Kingdom would suffer from a deficit of almost -6%.

## **II. An Alternative Policy Scenario to Address Global Imbalances**

In response to some of the adverse projections produced by the CAM's Baseline (policy-neutral) Scenario, Working Paper #141 devises an Alternative Scenario based on progressive policy assumptions that could potentially mitigate future global imbalances in GDP growth and current accounts.

For China, for example, these assumptions include an increase in consumption (corresponding to a reduction in savings) and a significant real appreciation of the Renminbi. For countries such as the USA, which are projected to have worsening current-account deficits, the policy assumptions include reductions in consumption and depreciation of their real exchange rates.

## **GDP Growth**

Under the above assumptions, GDP growth in China is projected to slow to an average of 5.6% during 2022-2026. In contrast, GDP growth in the USA would rise to 2.0% during the same period.

The slowing in economic growth in China would be driven by both a secular decline in its investment rate and a narrowing of its current-account surplus, as the real appreciation of the Renminbi and the rise in its consumption would raise its imports while lowering its exports.

Economic growth would also reach 3.1% in East Asian High Income countries during 2022-2026 (up from an average of 2.3% under the Baseline Scenario). Also, growth in the EU would edge up to 1.5% (instead of 1.2%).

### **Current-Account Balances**

China's current-account balance would also narrow, dropping to an average surplus of only 1.8% of GDP during 2022-2026 (compared to an average of 3.9% under the Baseline Scenario). The current-account surplus of East Asia High-Income countries would also decline—to 1.8% of GDP compared to 2.4% under the Baseline Scenario.

But the small current-account balance of the European Union would become even smaller, dropping to only 0.4% (compared to 0.8% under the Baseline Scenario).

What is most troubling, however, is that while the large current-account deficit of the USA would decline, it would still be ominously high, i.e., remaining at an average of -4% of GDP during 2022-2026. The projection for the United Kingdom would produce similar results: its current-account deficit would still be -4.7% of GDP by 2026. (This projection did not take into account the more recent vote for Brexit and the ensuing depreciation of the Pound).

### **III. The Impact on China of Projected Changes in Financial Flows**

Working Paper #141 also examines the effects of Net Financial Flows into China under the assumptions of both the Baseline Scenario and the Alternative Policy Scenario.

During the period 2000-2008 China's large and rising holdings of foreign exchange reserves dominated its capital account. By 2008, for example, such reserves represented over 5% of GDP. These holdings declined to some extent from 2009 to 2015 but over the same period China's holdings of Net Other Investment (such as through foreign lending) began to rise.

#### **Baseline Scenario**

The Baseline Scenario projects that China's gross *outflow* of capital would be 4%-4.5% of GDP over 2017-2026. This outflow would be driven mostly by the acquisition of foreign-exchange reserves

but it would be complemented by China's foreign lending flows, which would amount to about 1% of GDP.

Over the same projected period, the gross *inflow* of capital would hover around 1% of GDP, composed mostly of Foreign Direct Investment—supplemented, though to a very small degree, by inflows of portfolio investment.

Hence, the Baseline Scenario (which assumes no major policy changes) projects that China would have a net financial outflow on its capital account amounting to 3%-3.5% of GDP during 2017-2026—though this percentage would progressively decline to a low of 3% by 2026. (Note that in this Working Paper capital outflows are designated, unconventionally, as positive items while inflows are designated as negative items).

Hence, even under the Baseline Scenario China's net capital account would remain fairly stable. On the one hand, the outflow of capital would be dominated by China's acquisition of foreign exchange reserves and, on the other hand, its receipt of an inflow of capital would be dominated by Foreign Direct Investment. Hence, the net composition of capital flows into and out of China would likely remain fairly stable.

### **Alternative Policy Scenario**

The Alternative Policy Scenario for 2017-2026 produces a somewhat different trend for China's capital account but the basic dynamics and direction of change would remain. The trend of the Net Capital Account would be somewhat lower than that in the Baseline Scenario. From a level that is almost equivalent to 3% of GDP in 2017, it would progressively fall to under 2% by 2026.

As in the Baseline Scenario, China's holdings of foreign exchange reserves would still dominate its net capital account. While reaching a peak of about 4.7% of GDP in 2016, these reserves would progressively decline to 3.1% of GDP by 2026.

The inflows of capital into China would still be dominated by Foreign Direct Investment over the period 2017-2026. But while these inflows would increase marginally over this 10-year period, they would not move much beyond 1% of GDP. And they would be supplemented, though only to a modest degree, by inflows of Net Other Investment, i.e., banking inflows or loans.

Thus, unlike the net capital account position of a number of other major Emerging Economies, China is projected to maintain a fairly stable and positive net foreign investment position.

Its projected holdings of foreign exchange reserves, though reduced, would far outweigh, for example, its capital inflows. And such inflows would continue to be dominated by Foreign Direct Investment, which tends to be a more stable form of inward investment than either Portfolio Investment or Net Other Investment. It is these two latter forms of capital inflows (as well as outflows) that can have a destabilising impact on the net investment position of many other Emerging Economies—as documented in Working Paper #141 on Brazil and Indonesia.

#### **IV. Is China's Rising Indebtedness Sustainable?**

The projections produced by the CAM macro-econometric model for Working Paper #141 have provided useful scenarios for analysing the likely future trajectory of China's capital account. But data limitations have not allowed it to comprehensively assess historical trends and projections for China's total debt, both external and domestic as well as public and private.

Hence, the Working Paper has relied on various recent reports, such as from Moody's, McKinsey and the IMF, to produce estimates of such debt. Generating such estimates has become a priority since China appeared to be shaken by financial instability in late 2015 and early 2016. Since China is now such a large economy, a threat to its financial stability could destabilise global financial flows.

China's level of debt is now a major area of concern. In May 2016 Moody's estimated that its total debt had risen to 280% of GDP, a level that is higher than that of almost all other emerging or developing countries. But, within this total, China's external debt has remained fairly small, i.e., no more than 9% of GDP in 2014, and China appears to have had few problems in servicing it.

The debt of China's central government in 2015 was only about 17% of GDP, a very manageable level. But when all types of China's local government debt are included, the estimate of total public debt rises to about 60%.

Household debt is not estimated to be large: it is less than 40% of GDP and most of it is based on house mortgages. At the same time Chinese households have a fairly high savings rate so the probability of defaulting on such mortgages is not high.

Working Paper #141 finds that the most troubling form of debt in China appears to be corporate debt. Informal estimates by the IMF suggest that this form of debt could represent about 160% of GDP. But most of this corporate debt is owed by state-owned enterprises, which are backed up by

the government, and it has been financed by domestic bank loans or bonds, not foreign sources of finance.

Although much of China's debt, both public and private, appears to be manageable, it is still true that its total debt, as a ratio to GDP, has risen rapidly since the onset of the global financial crisis in 2008. Rough estimates claim, for example, that this ratio shot up from about 170% of GDP to 280% between 2008 and 2016.

Particularly worrying is that the number of non-performing loans in China's corporate sector and local governments does not appear to be negligible. For example, the IMF has claimed recently that about 15% of bank loans to Chinese corporations are at risk of not being repaid and it has publically warned about the rising problem of corporate debt. Also, a significant number of local governments do not appear to have the revenue sources that would enable them to repay their substantial public debts.

There still appear to be sufficient assets of governments and households to enable them to effectively manage their levels of debt. Moreover, China is likely to continue having a very large stockpile of foreign exchange reserves that it could mobilize to meet any external debt obligations.

China's government also continues to have significant influence over the financial activities of state-owned enterprises—as well as state-owned banks. Moreover, China's capital account has not been completely liberalised. In fact, capital controls were tightened in 2015 as private capital outflows began to increase.

In sum, Working Paper #141 concludes that although China's total indebtedness is rising, it appears, for the time being, to remain manageable. Both its high savings rate and the ample fiscal space of its central government could be used to guard against financial instability. In addition, its strong positive net external asset position could potentially be mobilized if its financial indebtedness (mainly by its 'private' corporations and local governments) began to reach unsustainable levels.

## VIII. Summary of Main Points

### India

The economic and financial trends in India reported by Working Paper #145 differ in some important respects from those reported by the working papers for most of the other major Emerging Economies covered by Deliverable 6.07. Financialisation, both in its internal and external forms, appears to be at a much earlier stage of development in India. Moreover, its economy is projected to continue growing at a fairly healthy rate over the medium term.

Yet this Working Paper raises some major concerns about the country's future prospects. For example, it warns that if current trends of financialisation continue, India's rate of economic growth could be significantly slowed by the reliance of the economy on investment in the financial sector instead of investment in the productive sector, especially manufacturing.

At the global level India is still a very minor player in financial markets. The country's share of external financial assets is projected, for example, to rise to only 1% of the global total by 2030. Yet if it continues to run sizeable current-account deficits, its net external liabilities will surely increase. In addition, the share of short-term portfolio liabilities in its total external liabilities is projected to increase by 2030 to over 30%—a share that would be much higher than that for China, for instance.

Credit as a proportion of gross capital formation in India had already risen to 200% by 2012 but one of the central arguments of the Working Paper is that much of this credit has been utilised for financial investments and inventory stock-piling instead of fixed productive assets.

As a result, economic growth has responded less than proportionately to increases in credit. Worryingly, the rate of return on financial investment is also likely to be higher than that for productive investment. Also, the build-up of inventories is likely to be a barometer of 'over-production', corresponding to a secular deficiency in domestic aggregate demand.

In view of these concerns, the Working Paper utilises the CAM global model in order to test the usefulness of an alternative policy scenario in which India's economy would be boosted by an expansion of domestic demand and a concerted export push. The main levers are an assumed increase in private investment and, to a lesser degree, an increase in foreign direct investment (which is assumed to be more productively oriented than other forms of foreign investment).

Because India is projected to continue being plagued by current-account deficits, this alternative scenario also assumes a depreciation of India's real exchange rate and an increase in its exports of manufactured goods.

But the scenario's concomitant projected greater opening of India's capital account to foreign investment would lead to a sharp increase in short-term unstable inward portfolio investment, which would rise to about one-third of the country's external financial liabilities by 2030.

Hence, while India's Net External Asset Position was still a positive 15% of GDP in 2015 (in contrast, for example, to the large negative positions of both Brazil and Indonesia), its move towards greater external financial liberalisation would likely heighten its *future* vulnerability to the instability of international financial flows.

## **Brazil and Indonesia**

Working Paper #141 focuses on two major Emerging Economies, Brazil and Indonesia, in which unstable international financial flows have been a major recent concern. Both of them are vulnerable to such instability because they have highly negative Net External Asset Positions. Such positions imply that the financial assets held by foreigners in these two countries are far larger than the financial assets owned abroad by their own citizens (or governments).

If the corresponding inward flows of capital by foreigners were used for long-term productive investment, such an imbalance would not necessarily be a matter of grave concern. Such could conceivably be the case, for example, for some forms of Foreign Direct Investment. But the two other categories of cross-border investment, portfolio investment and the residual category labelled 'other investment', tend to be short-term and often highly unstable.

When the financial rates of return for such short-term investment decline in countries such as Brazil and Indonesia, this capital is prone to quickly flee the country. This dynamic represents one of the most counter-productive aspects of the increased financialisation of such Emerging Economies.

When such rising economies are growing, they will tend to attract larger inflows of unstable capital because the rates of return on such investment would be higher than in Developed Economies. But when the economic growth of such Emerging Economies begins to falter—as has happened recently—this capital quickly floods back into global financial 'safe havens', such as US treasuries.

Working Paper #141 is particularly useful because it is able to place such financial flows within a global economic context through the use of the CAM global macro-econometric model. This model is particularly useful for making future projections based on long-term historical trends.

In fact, this working paper was revised in mid-2016 in light of dramatic changes in the global context that occurred in late 2015 and early 2016. These changes were taken into account by the CAM model when it was used to generate more up-to-date projections.

The general significance of the CAM's resultant 10-year projections (from 2017 to 2026) is that the global economy is likely to be plagued by persistently slow GDP growth and continuing stark economic imbalances, especially current-account imbalances. Such a context implies that there would continue to be re-occurring financial imbalances, marked by unstable capital flows between countries, particularly between Emerging Economies and leading Developed Economies.

Under the CAM scenario, Brazil is projected to eventually recover from its current sharp recession and grow at a moderate rate, namely 2%-2.5% through 2026. The country's current account would eventually regain its previous surplus position but, importantly, its rate of domestic investment would remain stubbornly low.

The composition of capital flows into and out of Brazil would also remain disadvantageous. Very little foreign direct investment would flow into the country while inflows of unstable portfolio investment would predominate. In addition, the government would have limited ability to counteract the effect of any rapid outflow of financial capital because it would hold a relatively small stock of foreign exchange reserves.

In some ways, Indonesia is projected to be in a somewhat stronger economic position than Brazil over the next ten years. By 2019 it is projected, for example, to begin maintaining a GDP growth rate of about 4%. Though its investment rate would tend to decline over the projected period, it would still remain at about 24% of GDP, far higher than Brazil's, for example.

However, Indonesia's current account would maintain a significant deficit throughout the projected period. Financial flows into Indonesia are projected by the CAM to decline from their current levels but then recover modestly by 2020. Most troubling, however, is that financial inflows would continue to be dominated by portfolio investment and 'other investment', the two most



unstable forms of capital inflows. And, as would be the case in Brazil, the government of Indonesia would command only a relatively small stockpile of foreign exchange reserves as a safeguard.

So both Brazil and Indonesia are projected to recover economically, to some extent, from the instabilities that they confronted in 2015-2016. But, on the whole, these recoveries would not be strong. Moreover, their financial fragilities would remain daunting, both because their Net Foreign Asset Positions would remain stubbornly negative and any continuing inflows of financial capital would be dominated by the most unstable varieties. So their financial positions are likely to be much more unstable than India's.

## **Brazil**

Working Paper #146 is a valuable contribution to Work Package #6 because it concentrates on the national and international consequences of the complex dynamics of financialisation in Brazil. Thus, compared to Working Paper #141, it goes into much more depth on such issues and is able thereby to draw out several important implications.

The authors' paramount point is that the process of financialisation in Emerging Economies such as Brazil is shaped fundamentally by their integration into an international monetary and financial system and this integration places them in a 'subordinated and disadvantaged' economic position.

The authors are concerned in particular about two "major channels of transmission" that integrate countries such as Brazil into the international financial system as well as decisively influence the nature of their domestic system of financialisation. The first channel is the obligatory accumulation by their governments of foreign exchange reserves and the second channel is their inevitable vulnerability to large and sudden movements of financial capital, which can heavily influence their exchange rates—even though such movements can be largely independent of trends in their domestic economic conditions.

At the level of the domestic economy, central banks in Emerging Economies have increasingly had to rely on 'sterilizing' the impact of new sizeable inflows of foreign capital. In doing so, they have used 'repurchase agreements' with domestic banks. This process has involved the exchange by central banks of domestic public debt securities with domestic banks in order to mop up the latter's excessive bank reserves.

But the banks have then perversely used such newly acquired public assets (the debt securities) as a basis to extend more private loans to finance either domestic household consumption or mortgages for housing. In the process, the households sector has become more 'financialised' while the banks have de-emphasized longer-term lending for domestic productive sectors.

At the international level, an Emerging Economy such as Brazil is still at a strategic disadvantage because it has to offer relatively high rates of return in order to attract international investor interest in its financial assets. It is also hindered by the fact that it faces major difficulties in issuing international debt instruments denominated in its own currency because of the ensuing 'exchange-rate risk' that international investors would argue that they will confront.

Moreover, the higher interest rates that Brazil is offering for international investors tend to have a knock-on effect on depressing the country's ability to promote domestic productive investment. Hence, Brazil's ability to independently establish the values of both its own exchange rate and its own interest rate is severely constrained.

In examining trends in Brazil itself, the authors draw out some interesting conclusions about the general impact of financialisation. Their first claim is that financialisation tends to lead to the incorporation of households into predatory credit relations. Their second point is that there is an increased reliance by banks on fees and income from financial trading, rather than from long-term lending for productive investment.

Moreover, the authors claim that banks have become increasingly reliant on funding from financial markets rather than from the normal acquisition of deposits. Lastly, they assert that non-financial corporations have also become increasingly reliant on financial markets for their funding. These phenomena appear to be common trends across many of the major Emerging Economies.

In addition, there is the inevitable accompanying increase in the array of financial investors in domestic firms, ranging from pension and insurance funds to exchange-traded funds and macro hedge funds. Thus, when there is even only a relatively small change in the sentiment of such investors and, as a consequence, they make only small individual changes in their portfolio of assets, there can still be major aggregate adverse repercussions on the entire economy of a country.

The authors of Working Paper #146 conclude that all of the above effects have tended to contribute to slower growth and greater financial instability in Emerging Economies such as Brazil as well as reinforce their subordinate and unstable position within an increasingly powerful global financial system. Many of these points appear relevant for most of the other Emerging Economies.

## **South Africa**

Working Paper #142 focused on the post-apartheid impact of financialisation on the South African economy. Since the landmark year 1994, the South African financial sector has increased, in fact, much faster than the economy as a whole.

But this trend has spawned a common secular process in which the rising acquisition of financial assets has coincided with a decline in gross capital formation. Financialisation has also deeply affected South African households, primarily through increased lending for mortgages and consumption. As a result, the economy had to confront by the 2000s a large real-estate bubble and an unsustainable consumption boom. This boom was fuelled, for the most part, by the large influx of short-term speculative foreign capital. Such a trend has been common across Emerging Economies.

Moreover, this process has led households to become indebted well beyond their means of income, thereby increasing the likelihood of periodic financial instabilities and crises. Once net savers in the South African economy, households have now become persistent net debtors.

The Working Paper argues that South Africa has become more financially open than most other comparable middle-income countries. Thus, similar to what has happened in other major Emerging Economies (e.g., Brazil, Indonesia and Turkey), the country has had to confront periodic financial crises, abrupt reversals of international capital flows, persistent volatility of its exchange rate, an unproductive domestic allocation of capital and persistent economic inequalities.

Such financial instability has led to substantial outflows of South Africa's own financial capital. The Working Paper reports, for example, that 37% of all reported South African assets were held abroad in 2014. Additionally, since 2000 onwards, the government has had to hold, as a defensive measure, a large stockpile of foreign exchange reserves—which bear the strategic disadvantage of being low-interest bearing assets. In addition, there has been a persistent rise in the outflows of dividends and interest payments to foreign investors.

In addition, inward financial investment into South Africa has increasingly been dominated by short-term volatile assets, especially portfolio investments. Since such inflows require relatively high domestic rates of return, portfolio investment is still likely to rapidly flee the country during any short-term economic or financial difficulties.

The Working Paper points out that South Africa has been afflicted by the rapid rise in the number of institutional investors in its economy. This has become a problem because their investment horizon is usually short-term and obsessed with financial-market metrics of success. As a result, real fixed investment and consequently economic growth has tended to suffer. The share of operating profits of non-financial corporations in South Africa has declined, for example, because they have been obliged to make constant and debilitating dividend pay-outs to a legion of such institutional investors.

Lastly and distinctively, the Working Paper argues that there has been a close correlation in South Africa between rising financialisation and increasing inequality—of both income and wealth. This correlation has been attributed to financial instability and resultant slow economic growth, the notable lack of productive investment, persistently high unemployment, the decline of the wage share in total personal income and the deterioration in labour's bargaining power over pay and working conditions.

## **Turkey**

Working Paper #143 provides a comprehensive account of Turkey's recent economic and financial development and the effects of international capital flows on the country. Turkey's development trajectory has been different from other major Emerging Economies because of its lengthy, and incomplete, process of accession to the European Union.

The country first adopted capital-account liberalisation in 1989 and the ensuing instability of capital inflows and outflows led thereafter to financial instability, particularly deep crises in 1994 and 2001. In the wake of the 2008 global financial crisis, Turkey also experienced a deep recession in 2009.

The Working Paper argues that, in effect, the country has become trapped in persistent current-account deficits that have to be covered by a constant inflow of financial capital. And the instabilities inherent in such capital inflows have, in turn, led to both lower and more volatile

economic growth. In this respect Turkey's conditions appear to be worse than those of many other Emerging Economies.

Turkey's economic development has been complicated by its relations with both the European Union and the Bretton Woods institutions. For example, the introduction of the EU Commission's *Accession Partnership for Turkey* coincided with the country's required implementation of structural adjustment programmes promoted by the IMF and the World Bank. However, despite adopting such policies, the accession of Turkey to the EU has turned out to be a very lengthy, 'open-ended' and politically frustrating process.

In the wake of its 2001 economic crisis, Turkey was obliged, nevertheless, to adopt many 'Post-Washington Consensus' economic policies. These included inflation-targeting, strict fiscal discipline, free-floating exchange rates and open capital accounts, as well as a greater emphasis on privatisation and reduced regulation of the labour market.

But the Working Paper argues that, as a result, Turkey's economy has been forced into a 'debt-led growth regime'. Ever since the 2001 crisis, the country's current account has been in deficit and this has necessitated constant international financing. Hence, the country has become endemically dependent on a persistent inflow of finance capital.

Moreover, Turkey has suffered from a relatively low rate of domestic savings, which has only served to intensify its reliance on foreign capital. Because of significant capital inflows, the economy has suffered from an appreciated exchange rate and the government has also been obliged to maintain relatively high real interest rates in order to continue attracting such foreign capital.

One of the strategic outcomes has been a process of de-industrialisation as the country has been obliged to rely heavily on low-value added export products. In order to maintain any international competitiveness in the face of an appreciated exchange rate, Turkey has increasingly relied on lowering labour costs. This has involved promoting much more flexible labour markets and has ended up maintaining a relatively high rate of unemployment.

Related to capital inflows, the size of Turkey's private-sector debt started to eclipse public-sector debt by the mid-2000s. Under structural adjustment, the government had been aggressively

cutting public expenditures, introducing new taxes and beginning to run primary budget surpluses. Thus, public debt as a ratio to GDP began to decline.

But over the same period the debt stock of non-financial corporations and households began to soar. Thus, Turkey's economic growth became more reliant on the domestic private sector's ability (particularly that of non-financial corporations) to borrow, especially from abroad.

In fact, the financial net worth of non-financial corporations has been much more negative than that of any other major category of the Turkish economy (namely, between -90% and -120% of GDP). And Turkey's net worth vis-à-vis the Rest of the World has become persistently negative.

Working Paper #143 makes a particularly valuable contribution to FESSUD Work Package #6 in its analysis of the monetary policies of the Central Bank of the Republic of Turkey (the CBRT).

Although the CBRT adopted inflation-targeting in the early 2000s, the erratic effect of international capital flows on Turkey's economy meant that this policy proved to be relatively ineffective. Fortunately, the accompanying appreciation of the Turkish Lira, as a result of capital inflows, helped contain inflation.

But, at the same time, appreciation has relentlessly widened the country's current-account deficits. Hence, the country has had to continuously attract a massive inflow of financial capital (averaging about 8% of GDP per year) in order to finance such deficits.

Unfortunately, since 2010 short-term, inherently unstable financial inflows (such as portfolio investment) have increased relative to long-term financial inflows (such as foreign direct investment). And the increasing influence of unstable financial inflows has also led to extreme volatility in Turkey's exchange rate.

But the central bank of Turkey has been unable to stabilise the Lira because flows of capital into and out of the country have been largely determined by the global appetite for risk rather than domestic economic trends. And the parameters for such risk are mainly determined by leading developed-country central banks, particularly the US Federal Reserve or European Central Bank. This is similar to the point made by the other Working Papers about conditions in Emerging Economies.

Hence, the Central Bank of Turkey (like central banks in other major Emerging Economies) has very limited policy independence. It has been continuously and unfavourably obliged to align changes in its policy interest rate with those instituted by the Fed or the ECB.

## China

Working Paper #144 is a valuable contribution to FESSUD Deliverable 6.10 because it attempts to place China's increasing financialisation within the context of a global economy that is slowing and continuing to exhibit wide disparities in current account balances (and accompanying instabilities in capital accounts). For example, the paper uses the CAM global macro-econometric model to project China's future economic and financial trends over the next ten years *within the context* of the evolution of the global economy.

Under the assumptions of a Baseline Scenario (which assumes no significant changes in policy), the CAM model projects, for example, that China would continue to grow fairly rapidly but it would also continue contributing significantly to global imbalances in current accounts, and thus associated major imbalances in capital accounts, i.e., international financial flows.

Also, while China would continue enjoying sizeable current-account surpluses, Developed Economies such as the USA and the United Kingdom (two leading global financial centres) would continue, by contrast, to suffer from large current-account deficits.

Hence, the author of Working Paper #144 constructs an Alternative Policy Scenario that could slow China's economic growth, change its pattern and narrow the country's current-account surplus. This scenario is based, for example, on assuming an increase in China's level of consumption (and a corresponding reduction in its savings rate) and an appreciation of its exchange rate.

As a result of such policy-related assumptions, China's rate of economic growth would slow significantly and its current-account surplus would narrow. But this adjustment of China's future path, as well as the effect of the Alternative Policy Scenario as a whole, would not be successful in helping to significantly lower the large current-account deficits of the USA and the UK.

What is also noteworthy is that the CAM projections suggest that China is likely to continue enjoying economic outcomes that would be superior to those of other Emerging Economies, such

as Brazil, Indonesia, South Africa and Turkey, all of which have been surveyed by Working Papers in this FESSUD Deliverable.

The external financialisation of China would also likely be much more sustainable than that of other Emerging Economies. For example, under both the Baseline Scenario and the Alternative Policy Scenario, China would maintain a fairly stable position with regard to inward and outward financial flows.

It would continue to amass a sizeable external stockpile of foreign-exchange reserves while the inward flows of capital into its economy would continue to be dominated by Foreign Direct Investment instead of the more volatile and erratic flows of Portfolio Investment and Other Investment.

Working Paper #144 also examines the external and internal debt dynamics of China, which have become a major area of concern for analysts since the outbreaks of financial instability in the country in late 2015 and early 2016. But the paper concludes that although China's total debt, comprising both external and domestic, has risen sharply in recent years, it is likely to remain sustainable. In fact, its external debt remains fairly small. Moreover, the country continues to amass a large strategic stockpile of foreign exchange reserves and it maintains fairly effective capital controls, both of which would help to mitigate any financial difficulties.

The main areas of strategic weakness in China appear to be the domestic debts of local governments and the corporate sector. In contrast, the debts of the national government and households are not large. Moreover, China continues to have a fairly high household savings rate and the national government appears to maintain adequate fiscal space and retains the ability to exert significant influence over the financing of state-owned enterprises.

Hence, although many analysts in advanced capitalist economies and even international financial institutions such as the IMF and BIS have recently raised serious concerns about the process of financialisation in China, the country's future course still appears to be economically sustainable.

In this regard, conditions in China would likely continue to contrast with those projected for the other major Emerging Economies of Brazil, Indonesia, South Africa and Turkey, all of which have been reviewed in this Synthesis Report. The one exception appears to be India, although this country appears to be at a much lower level of financial development.



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*Note: see each Working Paper for a more detailed bibliography.*

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## THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?'

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3	School of Oriental and African Studies	UK
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5	Pour la Solidarité, Brussels	Belgium
6	Poznan University of Economics	Poland
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