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FINANCIALISATION, ECONOMY, SOCIETY AND SUSTAINABLE DEVELOPMENT

Research Brief #1

The Financialisation of Emerging Economies: Lessons from Brazil

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I. Introduction

This Research Brief #1 for Work Package #6 of the FESSUD project summarizes Working Paper #146, which is entitled *'International and Domestic Financialisation in Middle Income Countries: The Brazilian Experience'*, written by Annina Kaltenbrunner, Leeds University Business School, and Juan Pablo Painceira, Central Bank of Brazil.

This paper argues that the process of financialisation in Emerging Economies such as Brazil is shaped fundamentally by their subordinated integration into an increasingly 'financialised' international monetary and financial system. The paper maintains that this perspective has been missing in the analysis of Emerging Economies largely because the existing literature on financialisation has been based mainly upon an analysis of financialisation in Developed Economies, largely in the Anglo-Saxon core of countries. At the same time, there has been very little systematic analysis of the distinctive nature of financialisation that Emerging Economies have had to confront. The paper focuses on the processes that shape financialisation in these countries.

The paper by Kalternbrunner and Painceira defines international financialisation as both a quantitative and qualitative change in the size and nature of international financial relations. On the domestic level, this definition points to the changing financial relations, practices and needs of key economic agents, namely, banks, households and non-financial corporations (NFCs). In Developed Economies, financialisation has been associated with several key developments: the increased incorporation of households into predatory credit relations through consumption credits and mortgages; the increased reliance of banks on fees and income from trading rather than lending for productive purposes; the rise in bank funding from markets rather than deposit taking; and the rapidly expanding involvement of large NFCs within financial markets.

On the international level, they argue that just as financialisation is more than just a quantitative increase in the size of the financial sector in an economy, international financialisation is more than just a rise in international capital flows. The key point is that these capital flows have changed their form and have become more complex and varied, and have progressively penetrated deeper into new economic and social arenas.

II. International Financialisation: The Changes in Financial Investment

At the international level, flows of capital have undergone important qualitative changes. The traditional investors from Developed Economies (such as banks and dedicated investment funds) have been joined by a wide range of other financial actors, such as institutional

investors (including pension, mutual and insurance funds) as well as new types of mutual funds (such as exchange-traded funds and macro hedge funds).

This expansion has resulted in a wide range of investment strategies and funding patterns. And because of the huge size of wide array of these investors, even a small reallocation of their portfolio shares can have a profound impact on an Emerging Economy.

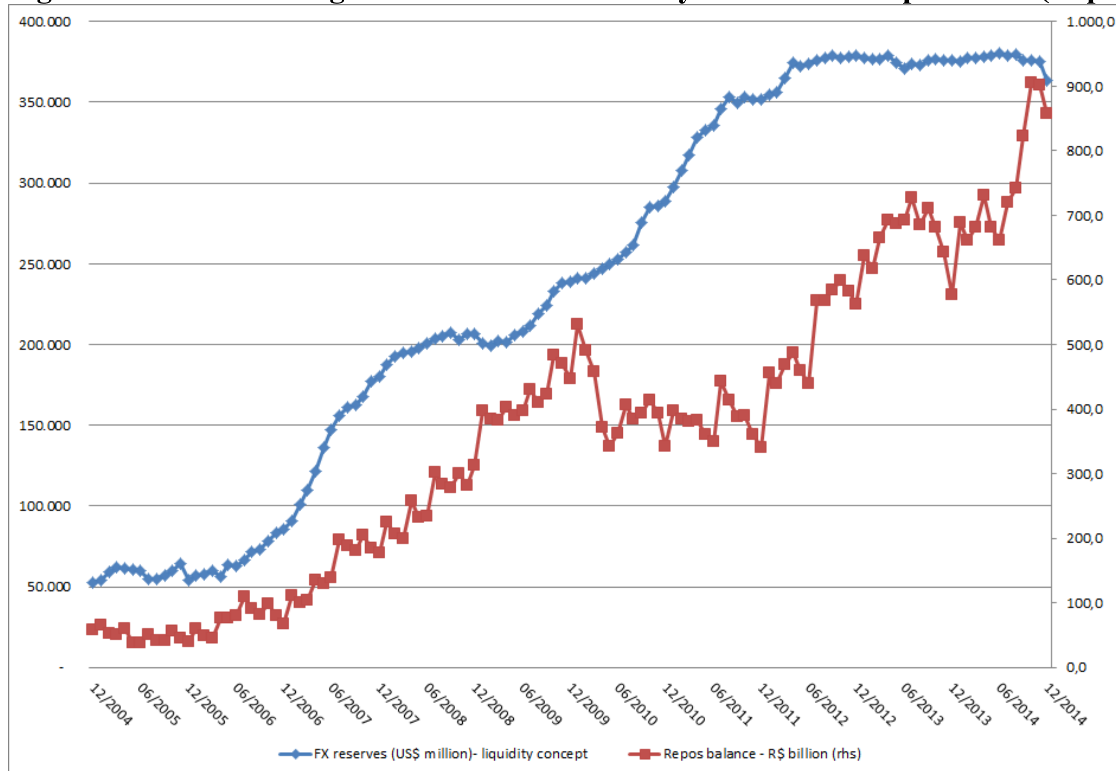
At the same time, this panoply of international investors have sunk money into an increasingly complex set of domestic current assets, including sovereign bonds, equities and financial derivatives, as well as a country's currency itself. For example, the participation of foreign investors in Brazil's stock market increased from below 25% to over 50% between 2003 and 2014. And by March 2011 Brazil's stock of short-term external liabilities stood at over US$880 billion, or equivalent to about 40% of GDP.

III. The Role of Foreign Exchange Reserves

In order to safeguard themselves from the volatility of such liabilities, Emerging Economies such as Brazil have resorted to accumulating vast stockpiles of foreign exchange reserves. By 2014 Emerging Economies held over US$8 trillion in such reserves. While Brazil's reserves had stood at only US$50 billion in 2004, they had risen to over US$360 billion in 2014 (See **Figure 1**).

A sign of the subordinated nature of Emerging Economies within the international monetary hierarchy is that they have had to amass such large stockpiles of reserves precisely in order to safeguard their domestic economies against large outflows of short-term volatile capital, which could rapidly flee back to the safety of globally liquid currencies (such as the US dollar, the British pound or the Euro).

Figure 1: Brazil's Foreign Reserves and Monetary Sterilization Operations (Repos)



Source: BCB (2015a) and BCB (2015b)

Figure 1 also documents that Brazil's accumulation of foreign-exchange reserves has roughly corresponded to the rapid increase in the issuance of 'repurchase agreements' (repos) by its Central Bank. Reverse repos are central bank operations in which bonds are sold (with an agreement to buy them back in the future) to Brazil's domestic banking system. The purpose is to contain excessive expansion in the domestic money supply (stemming from the central bank's FX purchases), which could trigger greater pressure on inflation. The Figure shows that 'repos' began to expand rapidly in Brazil in 2006, corresponding to the large rapidly rising inflow of short-term portfolio capital into its economy.

But what is the effect of such 'repos'? Brazil's domestic banks have used their purchase of 'repos' from the central bank as short-term assets that enable them to increase their own short-term liabilities. These liabilities in turn have allowed them to increase their lending to the domestic economy. However, given the short maturity of their liabilities, such operations cannot take the form of long-term lending to Brazil's productive sector. Instead, it is used for short-term lending to households, primarily for consumption. In other words, this process has led to 'rising financialisation' of the household sector itself. The provision of household credit is ideal for banks since it has a short repayment period (which matches the banks' repo liabilities).

IV. Adverse Consequences

The whole process just described has several adverse consequences for the economic development of Emerging Economies. We mention two major effects. First, the purchase of foreign-exchange reserves by their central banks implies a continuing transfer of resources to Developed Economies.

Moreover, the government bonds (such as US Treasury Bonds) that they purchase are assets with decidedly low yields (especially since the 2008-9 global recession and the ensuing policies of quantitative easing). Meanwhile, the short-term foreign capital that has flowed into an economy such as Brazil's is able to repatriate a fairly high rate of return on its investment.

The second disadvantage of such an increasingly 'financialised' relationship between Developed Economies and subordinated Emerging Economies such as Brazil is that the latter's domestic banks increasingly divert their previous lending for productive investment to household loans. As a result, capital accumulation is adversely affected and Brazil's potential for economic growth is restricted.

V. External Vulnerability

A major second consequence of the increased inflow of short-term speculative capital into an economy such as Brazil's is that it becomes increasingly vulnerable to large and sudden capital movements and exchange-rate volatility. And this variability in the inflows and outflows of foreign capital is often largely independent of the underlying movement in the fundamental factors driving its economy.

As an illustration of such a trend, **Figure 2** documents the volatile movements in the Brazilian Real between 2003 and 2014. And it compares these movements to the changes in the VIX, an indicator of changes in international market conditions—not necessarily, it must be emphasized, in conditions in Brazil itself.

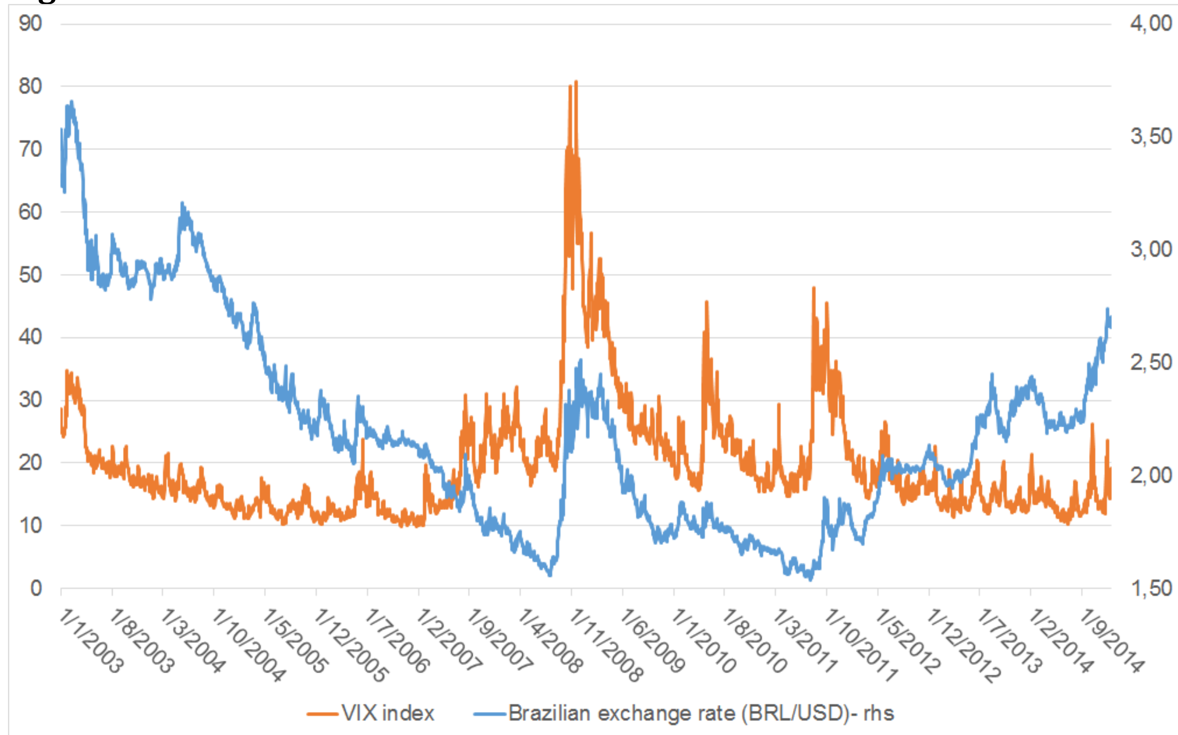
The Figure 2 shows that the Brazilian Real had appreciated from 3.6 Reais to the US Dollar in 2003 to 1.5 Reais in mid-2008. Thereafter, during the worst period of the international financial crisis in late 2008, the Real lost about 60% of its value. Then, after having regained most of its value by mid-2011, the Real plunged in value again in September 2011 in conjunction with the worsening of the Eurozone crisis.

Furthermore, by the middle of 2013, when the US Federal Reserve began to consider scaling back its policy of quantitative easing and raising its interest rate, the Real continued progressively to lose

value. This trend continued thereafter in 2014, primarily as a result of a fall in international commodity prices.

The sharp and sudden movements in the Brazilian Real are tied to the fact that there is a massive stock of short-term capital--largely funded in US dollars on international financial markets--continually moving in, as well as out of, the country's domestic economy. Even though such foreign investment can be denominated in Reais, it is concentrated, not in the productive sector, but in very short-term, potentially high-yielding but exceedingly volatile asset classes.

Figure 2: Movements in the Brazilian Real and the VIX Indicator



Source: Bloomberg

Any change in international funding conditions--that is, monetary conditions in the leading countries such as the USA--can lead to a repatriation of these funds, causing the large exchange rate movements that are independent of domestic economic conditions.

VI. Strategic Consequences of Financialisation

It is Brazil's congenital exposure to such large and unpredictable capital and exchange-rate movements that fundamentally shapes the relations of its economic agents with financial markets.

As part of this phenomenon, Brazil's own Non-Financial Corporations have ratcheted up their foreign currency borrowing on offshore markets. They have become increasingly active on international financial markets, both through investing in short-term assets and incurring inherently unstable short-term liabilities. This phenomenon has had adverse consequences for Brazil's economic development since NFCs' financial positions within Brazil have served to crowd out real productive investments.

Brazil's financial difficulties remain tied fundamentally to an international currency hierarchy, in which, for example, the US Dollar remains the world's dominant funding currency and remains relatively stable while the currencies of Emerging Economies, such as the Brazilian

Real, confront continuous pressures to depreciate and suffer from large and sudden losses in value during periods of international market turmoil. And this turmoil is often unrelated to the domestic economic conditions prevailing in those Economies.

One of the main purposes of this Research Brief (and the background Working Paper from which it has been drawn) is to highlight how the increasing financialisation of the international economy has served to maintain Emerging Economies such a Brazil in an inherently subordinate and unstable financial position. The self-reinforcing processes of such financialisation have relegated Brazil to such a debilitating position and exacerbated its uneven and increasingly unstable economic development.

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