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Financialisation and Development: how can emerging economies catch up?

Guizzo, Danielle and Strachman, Eduardo and Dalto, Fabiano and Feijo, Carmem

University of the West of England, UK), São Paulo State University, Brazil, Federal University of Parana, Brazil, Fluminense Federal Universtity, Brazil

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Financialisation and Development: how can emerging economies catch up?

Danielle Guizzo (University of the West of England, UK)
Eduardo Strachman (São Paulo State University, Brazil)
Fabiano Dalto (Federal University of Parana, Brazil)
Carmem Feijo (Fluminense Federal University, researcher at the Brazilian Research National Council)

Abstract

The influences of financialisation over emerging economies have drawn significant attention on whether these nations are able or not to overcome its constraints and promote satisfactory development levels. The possibilities for overcoming financial dominance, however, deserve further attention on what concerns its structural causes and policy alternatives. This article has two objectives. First, it formalises three key characteristics behind the financialisation of developing economies, focusing on some key elements that differentiate financialisation in developed versus emerging economies: interest rate behaviour; exchange rate volatility and balance of payments dominance. Secondly, it discusses some strategies for developing countries to overcome the effects of financialisation based on the hypothesis of increasing policy space, which allows these economies to retain autonomy on their macroeconomic policies and to conduct domestic policies in an integrated scenario.

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Introduction

The main defining element of financialisation is the integration[1] between the financial and the real sector. Even though finance has always played a primary role in capitalism (Hansen, 2014), recent processes of financialisation have incorporated the "large-scale expansion and proliferation of financial markets in the past thirty years (…), strongly associated with market mechanisms, complemented or even reinforced by policies that have underpinned rising inequality" (FESSUD, 2011, p. 3).[1] For Sawyer (2013), this second type of recent financialisation emerged together with neoliberalism circa 1980 as a new stage of capitalism in which financial processes became prevalent in the real economy.

The outcomes of such financial integration for developing countries (DECs)[2], however, are under increasing scrutiny. For instance, in the decade of 1980s, trade and capital opening was considered as the way out of the long stagnation period known as the 'lost decade' in Latin America, despite the evidences of low growth trends in the following years (Ocampo, 2004). Empirical evidences, however, suggest that financialisation had mixed results over emerging economies and at worst profound and adverse consequences over economic growth and general performance (see *inter alia* Carvalho, 2008).

The core proposition of financial liberalisation in DECs advocates free financial markets to attract excess of capital from developed economies.[3] Some have assumed, in favour of

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[1] For a review on the literature on financialisation in developing countries, see Bonizzi(2013).

[2] This article uses the terms "developing economies", "developing countries", and "emerging economies" interchangeably

[3] McKinnon (1973) and Shaw (1973) in the early 1970s were the main authors to provide a theoretical background to capital liberalisation to boost economic growth. They interpreted that the poor performance of investment and growth in developing countries would be due to the extensive use of interest rate controls and other instruments aiming at directing private credit to selected sectors. These restrictions would be responsible to impose a 'financial repression', which would be associated to inefficiency in the intermediation of resources by the financial system. Hence, the 'financial repression' would explain low savings rate, credit rationing and low investment, leading to low growth and eventually to economic stagnation. Capital account

financial liberalisation, that capital freed to move through boards would mostly behave in a counter-cyclical way (Forrest Capie, 2004).). Consequently, DECs would benefit from an increased supply of credit to boost investment and accelerated economic growth. Although financial integration is still praised as a strategy to promote development by international organisations such as the International Monetary Fund (IMF) (see *inter alia* Kose et al, 2003), empirical evidence does not corroborate the assumption that financial integration would stabilise net financial flows to all countries, even to the developing ones (Priewe, 2008). This became more evident after the inception of the current financial crisis (Ocampo, 2011; Palley, 2013). Moreover, data does not show that the process of capital opening that started in the 1980s and deepened in the 1990s has put DECs in a catching up path with the per capita income levels of developed nations (Kaltenbrunner, 2010; Carvalho, 2013). On the other hand, recent developments also show that not all developing countries have been equaly policy constrained even when subjected to more opened capital movments and facing the international financial crises The central point of this article is that however financial integration of developing economies narrows their policy space, or their ability to pursue domestic economic policies, we shall consider which factors might be key to determine the extension of that constrain. That is to say, however it seems uncontroversial that the lower rank position of developing countries in the world hierachy of currencies may narrow domestic policy space, it is also evident that capital flows are not always the all dominant factor determining domestic policy space.   .

The article is structured as follows: sections 1 to 3 present three economic particularities of developing nations and investigate under which conditions capital flows may lead to higher nominal and real interest rates, higher and more volatile exchange rates, and loss of policy

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liberalisation and liberal reforms of the financial system would, then, provide the alternative to increase domestic saving and investment, allowing greater capital flow through loans to domestic banks, and foreign direct and portfolio investments. In more general terms, financial liberalisation would enable a better global allocation of savings and help channel resources to the productive sector, increasing the economic long-term growth rate of developing countries (Carvalho, 2008).

space in the face of balance of payments dominance, as described by Ocampo (2011). In this context, two direct consequences of the management of macroeconomic policy stem from the dependence of financially integrated DECs: first, nominal and real interest rates tend to remain relatively higher than they could be, as well as comparatively higher than in developed countries; and secondly, the persistence of the interest rate differential impacts the real exchange rate, which tends to be chronically appreciated and volatile, given the existence of disturbing elements on developing countries, such as misalignment and hierarchy issues. Due to these trends, these economies hamper their own long-term capacity to grow, and their fiscal policies are usually pro-cyclical, thus limiting their very space for growth policies. More specifically, we point out that two of the main macroeconomic prices – real exchange and interest rates – are affected by financial integration and present high volatility, therefore restricting domestic long-term decision-making possibilities. This will also impact, as we will show, on the other two macroeconomic prices, i.e., fiscal prices (taxes) and wages. Section 4 proposes key strategies for overcoming increasing financialisation insofar as it affects growth and development strategies. We specifically address the issue of policy space as a possible alternative to increase policy autonomy in DECs. A final section concludes the article.

1. Interest rates behaviour in financially integrated developing economies

Since the early 1980s, when the monetarist experiment failed in the USA and elsewhere to control money aggregates (Friedman, 1988) it seems to have emerged a new robust consensus – accepted by mainstream central bankers and academic economists of various persuasions – that Central Banks have no choice but to set an interest rate target and then accommodate any demand for reserves at that target (Kaldor, 1982; Moore, 1988; Wray, 1992; Lavoie, 1996). In other words, money supply is endogenous and the overnight interest rate is exogenously set by Central Banks; and reserves will be provided by the Central Bank to commercial banks according to their demand at the Central Bank's target rate. As such, banks' liquidity

preference will be match by changes in the proportion of reserves to yield-bearing securities instead of changes on interest rates.

If, for instance, banks' reserves are below the required (either by law or by banks' liquidity preference reasons), they would sell bonds or treasuries or some of their own credits to the Central Bank and recover reserves; if, on the other hand, they have got more reserves than they need, they would buy treasuries from Central Banks or increase their loans, etc. (Fontana, 2004). Thus, meanwhile interest rates are exogenous, the composition of reserves to yield-bearing securities is endogenous. This composition will change according to liquidity preference and security preference considerations: a) banks have an overdraft with the Central Bank to satisfy required reserves; b) banks and the entire banking system must ensure an orderly payment system; c) banks' reserve demand is highly inelastic to interest rate, which would lead to a highly unstable interest rate if Central Banks did not provide it on demand.

Under the new monetary consensus, the management of the interest rate by the monetary authority should be a powerful instrument to administrate aggregate demand. But when considering developing economies financially integrated, how would the Central Bank adjust its domestic interest rate according to foreign interest rates? Our main argument is that any country with a sovereign monetary system may keep its freedom to determine domestic monetary policy (i. e., the basic rate of interest) as long as it does not try to follow a fixed exchange rate policy and does not allow "too much" indebtedness in foreign currency. "Financialisation" – increasing indebtedness in foreign currency - may lead countries to catch themselves in one or both traps leading to what Ocampo (2011) describes as a balance of payments dominance.

Most conventional analyses of an open economy are derived from the well-known Mundell-Fleming model, which states that monetary autonomy is an expected result for a small economy under floating exchange rate and perfect capital mobility, and an ineffective policy under fixed exchange rate. This conclusion is based on the uncovered interest rate parity theory of the exchange rate (Carvalho, 2009), which can be expressed as $i = i_* + e_e + \psi$, where the domestic interest rate, i, is equal to the international rate, i_*, plus the expectation of exchange rate (de)valuation, e_e, and the country risk premium, ψ. Any difference between i and i_* would imply a variation in e_e or in the country risk or in capital net inflows/outflows.

Nevertheless, from our endogenous money/exogenous interest rate and assuming Minskyan financial markets perspective, the Mundell-Fleming model adopts wrong (or unfeasible) assumptions about the behaviour of capital flows and monetary policy. As we argued above, Central Banks must always decide which interest rate to target, so it can never have control over money supply, whatever exchange regime or assumption on capital movement. Therefore, Central Bank may not lose what it has never had. To repeat the argument, Central Banks exercises control only over the interest rates. On the other hand, whatever capital flow happens the Central Bank must still fix the basic interest rate. With Central Bank fixing domestic interest rates, capital movements might have effects only on the rates of exchange and on the exchange reserves. Still, the extent of effects of such capital movements will depend on Central Bank exchange policy and its exchange buffer stock.

Another wrong assumption is perfect mobility, which implies plain substitutability amongst assets of different countries.[4] In relation to developing countries, it is crucial to recognise the structured hierarchy amongst currencies as well as amongst assets denominated in different currencies, hierarchy which is also determined by a differentiated currency capacity to

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[4] Furthermore, financial markets do not work under efficient markets assumptions but under Minskyan's financial instability hypothesis.

denominate and settle contractual payments (Kaltenbrunner, 2015; Guzman et al., 2016). In such cases, capital mobility may not be infinitely elastic to interest rates differentials as capital flows are not only attracted by the premium paid by domestic assets but also by liquidity considerations (this shall be addressed in the next sections).

Given the unstable and structured hierarchy of international capital markets and the exogeneity of interest rates, one should reconsider the policy combinations open to Central Banks and its consequences. When international investors have lower liquidity preferences, countries with larger interest rate differentials attract those investors' capital. With fixed exchange rates, capital inflows will result in an increase of banking reserves and/or of public debt. That is, either capital inflows build in commercial banks' reserves or they purchase public bonds directly. Banks will either keep the excess reserves, buy treasuries or retire their own debts with the Central Bank. In any case, as Central Bank fixes basic short-term interest rates, it agrees to buy or sell any amount of reserves or treasuries the banking system requires. So, as put by Lavoie (2001): "With fixed exchange rates, sterilization occurs automatically".

Thus, Central Bank could increase its foreign reserves indefinitely without losing the control on the short-term interest rate. Clearly, if doubt arises about the Central Bank's capacity to keep exchange rates fixed, capital outflows may force the Central Banker to increase the rate of interest or, conversely, heavy inflows may induce it to decrease interests. However, it is neither an automatic nor an endogenous mechanism, mainly if there are no doubts concerning the capacity of the Central Bank to maintain stable the exchange rate. In fact, it is still a political decision to be taken by the Central Bank. In sum, although there is an asymmetric capacity for Central Bank to keep the rate of interest below or above the international rate

under a fixed exchange rate, to fix the rate of interest is a policy determined by the Central Bank and cannot be changed endogenously by capital flows.[5]

On the other hand, with flexible exchange rate, surplus (deficits) in the balance of payments, caused by positive (negative) differentials between domestic and international rates of interest, would lead to permanent appreciation or permanent depreciation of the exchange rate up until the Central Bank decided for another rate of interest compatible with a new equilibrium of the Balance of Payments. So, there is also no automatic mechanism, as supposed in the Mundell-Fleming model, which would bring the domestic rate of interest to the international level. The Central bank would just maintain/alter its interest rates depending on the uncovered interest rate parity and on the net capital inflow/outflow.

Actually, the sustainability of any exchange rate regime (either fixed or flexible) depends rather on the country's capacity to pay its external obligations. If a country can borrow abroad in its own currency, it will profit from a low interest rate premium and high exchange rate stability. Conversely, if a country cannot borrow in its own money abroad, it will increasingly face difficulties to keep the exchange rate stable meanwhile the interest rate premium will be higher.

In this latter case, but assuming there is no variation in the country risk, the exchange rate should move to compensate for the investors' financial gains measured in the same currency. Thus, the interest rate parity equation establishes a relationship between monetary policy and the international capital market and, as long as the monetary authority is willing to let the

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[5] In other words, with a fixed exchange rate, the authority can also maintain stable the interest rate, but with the reserves working as flexible variable, adjusting according to net capital inflows. However, it is clear the asymmetric capacity of Central Bank to defend a fixed exchange rate under capital inflows compared to situations of capital outflows: to buy foreign currency the Central Bank would have no given limitation; meanwhile, its capacity to sell foreign currency would be determined by its possession of finite reserves.

exchange rate bear the burden of the adjustment, it will keep its autonomy to set the domestic interest rate.

Therefore, the autonomy to set the interest rate to control aggregate demand is much constrained in the case of DECs, mostly when financially integrated and under any sort of difficulty in their external accounts (Kaltenbrunner, 2015; De Paula et al., 2017). For in this circumstance, the monetary authority may be prone to accommodate changes in the direction of capital flows using the interest rate differential as *the* ultimate instrument. If, for instance, a high instability in the foreign exchange market is observed, the threat of a devaluation put pressure on the domestic interest rate to keep domestic assets attractive, and so an appreciation of the exchange rate is expected. The systematic increase in the interest rate differential, because of such a rise in the domestic interest rate, could represent an additional incentive to net capital inflows, which would be directed to assets that shall appreciate *plus* the increased rates of interest. Therefore, under unstable expectations in relation to the behaviour of the exchange rate, periodical expectations of exchange rate appreciation should be added to the yields obtained from the interest rate differential, followed by sudden reversals of expectations in the other direction, i.e., of depreciation, which would only be contained – using exclusively market mechanisms, when possible – through steep increases of the interest rates.

In sum, capital flights or capital floods imply that the interest rate parity theory is violated, as monetary authorities tend to accommodate exchange rate fluctuations mainly through the manipulation of the interest rate. This is the reason why real interest rates tend to be chronically higher in financially integrated developing economies and the real exchange rate time and again tends to be appreciated (Ocampo, 2011).

2. Financialisation and exchange rate volatility

Changes in the exchange rate can lead to severe consequences for the control of the economy and its growth. This section elaborates on the impacts of financialisation to the exchange rate movements, emphasising the mechanisms and effects of exchange rate volatility in DECs.

It is central for understanding the likely impacts of capital movements on DECs exchange rates its position in the international money hierarchy. Positions in this hierarchy are mainly determined by the ability of corporations and governments of a region to issue external debt in domestic currency. Thus, top ranked countries can issue external debts in their own currency – on the very top is, nowadays, the US Dollar - and low ranked countries – like DECs – cannot issue external debts in their own currency. Therefore, they must pay a higher liquidity premium for issuing debts denominated in a foreign currency. Capital movements seeking higher yield and lower liquidity, or alternatively capital movements seeking security may render a DECs' exchange rate to be considerably volatile. Given such position in the structured international financial system, the space of DECs to stabilise exchange rates is conditioned by the proportion of their debt denominated in foreign currency to their foreign assets.

One of the key aspects of the post-Bretton Woods era is to allow a globalised monetary and financial system in which short-term capital movements can lead to changes in exchange rates, though the purported aim of this modified system, in relation to the original fixed rates, is to bring about a strong stability. In a financialised world, however, the impacts over prices and volatility of investments in assets such as currencies are more intense, thus affecting the ways monetary policy and exchange rate management are conducted. As Minsky (1993, p. 16) points out, these short-term capital movements can be speculative moments attracted by anticipated exchange rate changes, mainly driven by short-term expectations of profit generation (Harvey, 1991) and risk-diversification. In this case, the exchange rate of DECs,

which can be added to short-term interest rates differentials, represents an asset that agents will hold with the expectation of increased future returns.

Indeed, with the intensification of global financial activities, exchange rate speculation has gained increased participation in asset classes due to its role in increasing capital gains, which can affect the movements and tendencies of these very exchange rates. For instance, the exposure of foreign investors to short-term domestic currency risk can exacerbate exchange rate movements and tighten the link between international market conditions and exchange rate movements, affecting domestic macroeconomic management (Kaltenbrunner, 2010; 2015). Noteworthy that exchange rates movements in developing economies can drastically differ from developed economies, because of the currencies hierarchy, with also dissimilar volatilities over time and impacts over policy-making, thereby providing several elements for rethinking the diversity of monetary and growth policies.

First, currencies of emerging countries have a lower liquidity premium in comparison to globally-dominating currencies, such as the US Dollar. This suggests the existence of an international asymmetry of currencies, or a 'currency hierarchy', in which "in times of increasing uncertainty, these assets are the first victims of the 'flight to quality' (i.e., to assets denominated in the key currency) by global investors" (Herr, 2008, p. 165). In other words, the international monetary system presents an institutional arrangement that is organised around a national currency, which has become the key currency for performing the three functions of money on the international scale: means of payment, unit of account (and denomination of contracts), and store of value (international reserve currency) (De Paula et al., 2017).

Second, exchange rates of developing economies tend to be more volatile and suffer from 'exchange rate misalignments', presenting a persistent deviation from current to long-term

equilibrium values, leading to an over/undervaluation over time. As demonstrated by Oreiro *et al.* (2012), a persistent trend of overvaluation of the exchange rate can negatively affect both the current account balance and growth rate, what is worsened by the fact that peripheral economies often renounce to control exchange rates via 'capital management techniques' (Epstein *et al.*, 2004), that is, capital controls. Such overvaluation occurs because of the links between interest rates and exchange rates, as pointed out in section 1, in which high interest rates cause an appreciation of the exchange rate.

Lastly, exchange rates suffer pressure from the volatility of global capital movements, affecting private and public debt and penalizing long-term growth. In this scenario, pro-cyclical monetary policy will inevitably lead to an appreciation trend of the real exchange rate which, through many channels, negatively affects the level of aggregate demand and the long-term growth rate. Ocampo (2011) mentions two channels through which exchange rate fluctuations affect **short-term** growth: a) the first are the effects that exchange rate fluctuations have on private sector balance sheets, where the private sector is a net borrower in international capital markets. In this case, appreciations during booms generate capital gains that tend to increase aggregate demand, whereas depreciations during crises generates capital losses and recessionary effects; b) the second effect is on real wages: appreciation tends to increase real wages, thus begetting an expansionary effect, whereas depreciation during crises generates the opposite effect. The **long-term** growth rate, on the other hand, is affected by the permanent appreciation trend of the real exchange rate, which contributes to early deindustrialisation.

More specifically, Kaltenbrunner (2015, p. 433-434) analyses the tendency of DECs currencies to over-appreciate and to maintain higher interest rates than in developed

countries, mainly in a context of capital liberalisation. Following Keynes (1936, chapater 17) and Chick (1983) formal terminology, we have:

$$(q - q^*) + a = (l^* - l) \qquad [1]$$

Meaning that the asset yield q, in our case, the interest rate of a DEC currency yield, compared to q^*, the world reserve currency yield (this specific interest rate), plus an expectation a of appreciation/depreciation against that same world reserve currency, will equal the liquidity premium l, "the ease of an asset's conversion into this same money numeraire" (Kaltenbrunner, 2015, p. 430), compared to the liquidity premium l^* of the world reserve currency, the world quintessence of "money". Thus, "a currency's yield differential $(q - q^*)$ has to compensate for its lower liquidity premium relative to that of the leading currency $(l^* - l)$ if demand for it is to be maintained."(*ibid* p. 433). Rearranging the equation above, we obtain:

$$a = (q - q^*) + (l^* - l) \qquad [2]$$

Equation 2 clearly shows the appreciation bias of a DEC currency under capital liberalisation. When q is considerably higher than q^* it surpasses a mere equilibrium compensation for the differences in the world liquidity premiums (with $l^* > l$) of the two currencies under scrutiny: "Currencies with high and stable international liquidity *premia* can offer low yields. This also means that monetary authorities in these countries can affect the value of their currencies with minor interest rate changes, granting them monetary autonomy." (*ibid* p. 434).

Thus, at the same time as the leading currency can offer the lowest yield, currencies at the bottom of the hierarchy need higher yields, often prohibitive, to induce demand for them:

"This is particularly the case when international liquidity preference increases and/or monetary conditions for currencies with higher liquidity *premia* change…. a sudden increase in liquidity preference might lead to exchange rate movements irrespective of high interest rates or domestic economic conditions. The impact of this change will be larger the lower a currency's liquidity premium." (*ibid* p. 434). As Keynes pointed out, the liquidity premium of money is associated to the fact that contracts are fixed in terms of money. So, there is an obvious advantage "of holding assets in the same standard as that in which future liabilities may fall due…" Therefore, liquidity is intrinsically related to the ability of a country to issue foreign debts in its own currency. Liquidity premium stability will depend on the capacity to pay foreign debt. It will be so much stable as a country can issue foreign debt in its own currency or when it holds assets in the same standard as its liabilities fall due in the future. In sum, the currency which serves as standard to contracts of foreign debts bears higher stability of liquidity. Since only a currency remains at the apex of the hierarchy, even the DECs that can display sound economic policies will perceive the difficulties to climb the international monetary hierarchy and to maintain stable their liquid capital flows, exchange rates and growth.

Some solutions are summarised as follows. Ocampo (2011) suggests that an alternative way of reading the 'trilemma' of economic policy in DECs – that is to say, how to keep monetary policy autonomy, low volatility of the exchange rate and free capital flow movements – is that economic authorities should pursuit a mix of possibilities among different degrees of autonomy of the monetary policy, foreign exchange intervention and capital mobility restrictions. A broader Keynesian alternative, which would include a revision on the organisation of the global monetary system, focuses more specifically on adopting: (1) fixed exchange rates, (2) provisions to control capital flows, and (3) trigger mechanisms for automatically adjusting Balance of Payments disequilibria, shifting the burden of resolving

trade imbalances especially on the surplus economies (Davidson, 1994; Andrade and Prates, 2013). A Minskyan approach would involve a set of measures that could protect developing countries, in order to reduce their financial fragility not via exchange regimes (fixed or floating), but by building financial and real capital buffers to avoid systemic fragility (Kregel, 2004).[6] Here, building 'real' capital means to use foreign lending to increase the share of net exports in GDP, increasing foreign exchange earnings and reserves (Romero *et al.*, 2011); whilst building 'financial' capital means to increase lenders' confidence in their decision to lend, increasing capital amounts.

3. Balance of Payments dominance, pro-cyclicality and financialisation

Ocampo (2011, p. 21) defines Balance of Payments dominance as the "heavy influence that the balance of payments exercises on short-term macroeconomic dynamics of developing countries – i.e., the dependence of domestic business cycles on external shocks, positive and negative, that are transmitted through the balance of payments". As most of these pro-cyclical shocks are associated with boom-bust cycles in external financing[7], policy challenges are not only restricted to the appropriate management of these shocks, but also the need to widen the space for countercyclical macroeconomic policies, in opposition to the trend of macroeconomic policies in such stances to behave in a pro-cyclical way.

Thus, short-term capital flows to developing countries have been mainly pro-cyclical, increasing the macroeconomic volatility of these economies, and undermining their growth

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[6] Rey (2015), in an influential paper, shows that no matter the exchange rate regime, the volatility in the exchange rate of DECs is due mostly to the monetary policy administration in developed countries.

[7] Also for Kaltenbrunner (2015:p. 443), "it is DEC's exposure to short-term capital flows and their asymmetric and hierarchic integration in the international monetary and financial system itself – rather than adverse fundamentals, as in neoclassical economics, or a country's lack of monetary credibility… – that underpins and perpetuates their monetary subordination." As DEC's currencies are more unstable, they are more prone to speculation, feeding back that instability, and so on. Rather paradoxically, good fundamentals can increase capital inflows generating dynamically more instability, because of the inevitability of the reversal of capital flows, even if a DEC maintain its good fundamentals, since the outflow can be initiated abroad, as in the 2008 crisis.

prospectus (Ocampo and Stiglitz, 2008). Such pro-cyclical nature of capital flows is observed either when foreign lenders sharply cut new lending and refuse to roll over old loans when they are more needed (since lenders' expectations become risk avert – Minsky, 1986; 1993) or when domestic investors, anticipating currency depreciation of their currencies, precipitate a capital flight (Guzman *et al.*, 2016). These patterns have been largely registered, for instance, in most Balance of Payments crisis of the 1990s in Asia and Latin America. Moreover, the instability in capital flows is not only observed in short-term speculative flows, but also in longer term portfolio investments, including foreign investment. Although volatility in this latter case is much less accentuated, nowadays foreign investment occurs mostly in bonds issues and bonds financing which are also strongly pro-cyclical.[8]

Financially integrated DECs that maintain an open capital account in their balance of payments, with relatively high external debt in foreign currency, will have to keep a permanent necessity to raise interest rates in order to keep liquid capital inflows. Consequently, an important feature of DECs with an open capital account is the necessity to absorb foreign "savings" from private markets, drastically reducing their policy space. In open economies with free capital market the policy space is also dictated by the perception of the international financial markets about the ability of these economies to fulfil their financial commitments in foreign currency. Even though this may be the case for both developed and developing economies (in which this evaluation greatly determines their financial stability), for developed countries this instability does not affect their performance significantly as they

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[8] Ocampo and Stiglitz (op. cit) point out four reasons why foreign investment is pro-cyclical: "First, FDI will be correlated with global fluctuations. The global financial crisis of 1998 led to a reduction of FDI everywhere. Second, much of what is classified as FDI is sometimes really 'finance'. For instance, privatisations and mergers and acquisitions are categorised as FDI, even though they often represent an ownership transfer rather than new investment. It is therefore important to distinguish between new 'greenfield' investments and mergers and acquisitions. Third, to the extent that FDI is geared toward the domestic market, it responds to economic booms and downturns in much the same way domestic investment does. Fourth, foreign direct investors know that it might be difficult to sell their assets during a crisis, so they often use derivative products, such as currency forwards and options, to sell the local currency short as a hedge of their investment, adding to a run on the currency during a crisis."(2008, p. 20).

are able to issue debts in their own currencies – even if in reduced amounts compared to the main world currency –, which can reduce their potential economic instability and an eventual dependency of foreign reserves.

Although most DECs demonstrate an alignment with the "good policy fundamentals" (Kaltenbrunner, 2010; Guzman *et al.*, 2016) – in terms of inflation, central bank independence, foreign exchange reserves, etc. – DECs remain externally vulnerable and need to keep structurally high interest rates and, thus, a monetary dominance, despite their good behaviour and performance: "The current impact of quantitative easing (and its potential withdrawal) on DECs' exchange rate is just one example of this continued monetary subordination. For example, the Brazilian real appreciated from nearly 4R\$/US\$ at the end of 2003 to 1.5R\$/US\$ in August 2008, to then lose around 60 percent of its value during the global financial crisis. Similarly, the Colombian peso and Korean won both lost 13 percent in a month during the international financial crisis, largely independent of domestic economic conditions." (Kaltenbrunner, 2015, p. 435, footnote 12). This instability will be more conspicuous as a DEC is considered riskier by the international markets (Ocampo, 2011).

A DEC may face increasing pressures to expend reserves to defend its currency[9] or, if a depreciation (ultimately) occurs, it will face augmented debt obligations – either private or public –, which has at least four possible outcomes. It can either a) foster liquid exports and economic growth; b) restrain private investments or even the solvency of some enterprises because of their foreign debt, compromising investment and growth levels; c) affect public investments and public expenditures in general, fostering pressures for austerity measures (Blyth, 2013); and d) face high fluctuations in exchange rates that can affect inflation rates and economic policies as a consequence. Therefore, net capital flows will perform a pro-

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[9] This is one important reason why many DECs have been accumulating large amounts of foreign reserves, that is to say, to be able to defend their currency exchange rate whenever its Central Bank wants (Ocampo, 2011).

cyclicality loop as booms tend to stimulate currency appreciation and a reduction of external prices (of finished consumer goods, capital goods and/or inputs), bringing more favourable conditions to economic policies – while in busts the opposite shall occur with capital outflows and depreciations (Ocampo, 2011).

Indeed, the balance of payments dominance view explains why macroeconomic volatility is increased in DECs with an open capital account and high external debt in foreign currency. In these economies, capital account plays an important role in causing pro-cyclical shocks, and financial cycles are stronger for 'riskier economies' because of their 'imperfect' integration into the global financial market (Guzman *et al.,* 2016). Risk evaluation can lead to an easy access to credit during the boom, when international liquidity is plentiful and the inflow of foreign capital is in excess to merely finance a balance of payments equilibrium, but then it can revert to credit rationing and the worsening of conditions, when international liquidity is scarce, leading to balance of payment crises.

Despite the policy options offered in the literature for globally financialised emerging economies, the effects of financialisation over DECs still lack alternatives to tackle its negative consequences. The next section explores this issue by offering an increased policy space as a viable option for financially integrated developing economies.

4. Increasing the policy space as an alternative for financially integrated developing economies

As explored throughout sections 1 to 3, financially integrated DECs face an autonomy challenge regarding their diminished policy space. In this section, we will sketch some general suggestions to amplify the available space for clear development policies.

First, following Keynes's *Treatise on Money* (1930) and Kregel (2008), capital controls must be addressed as a form to increase policy space. As Kregel (2008, pp. 14 and 16) suggests, "Keynes is arguing that financial liberalization precludes a country from using monetary policy to offset fluctuations in domestic investment, rather requiring the use of interest rates to influence international capital inflows. The loss of policy autonomy was thus caused by a policy conflict – low interest rates, required to offset a decline in domestic investment would cause a decline in foreign investment. (…) Or, as Keynes had already noted, monetary policy had become the hostage of international capital markets." These controls should be available for short and long-term capital flows insofar as capital flows may be invested under the guise of foreign direct investments, but actually constituting "financial capital". Such tendency can be seen in many cases of privatisations and mergers and acquisitions, which were in essence ownership transfers rather than new investments (Ocampo and Stiglitz, 2008).

Capital controls should be accompanied by restrictions to foreign borrowing, both by private and public agents. This would avoid foreign obligations and currencies mismatches between gains in domestic currency and obligations in foreign currency, as well as underlying pressures against currency depreciation. Indeed, following Ocampo (2011), "control" is generally used to refer to interventions in the capital account, rather than a "regulation" of capital flows, which are of a similar nature to other types of regulations; they may be quantitative in character (such as prohibitions) or price-based (such as reserve requirements on capital inflows). These actions focused on avoiding excess capital inflows are clearly *prudential* in character, as they aim at correcting the risks associated with such excess inflows.

However, when strong capital inflows cannot be hindered, a country should sterilise these inflows by, for instance, requiring a minimum stay in the country and increasing reserve

requirements if the inflows are to 'finance' bank lending in the domestic market, or even if the liabilities are due to non-financial firms[10]. Tax provisions could also be used, for example, to limit the tax treatment of external debt services (Ocampo, 2011).[11]

Secondly, such restrictions to foreign borrowing must be followed by strong efforts to develop domestic financial markets as there will be the need to finance investments in real capital, R&D and other forms of productive investment. This financial structure should be complemented, when possible, by national development banks as an opposition to liberal measures that deregulate financial systems (Kregel, 2008). Hence, a complete "policy package" would require the effort to support a full-fledged financial system with enough credit to clear investment decisions and with low and stable interest rates, improving the economy's fiscal stance.

Thirdly, rather flexible but competitive exchange rates could be an adequate option in an administered regime, which would not allow full exchange rates fluctuations and its underlying instability, which often comes with costs and return expectations. Wray (2012), for instance, mentions that for nations with sovereign currencies, a floating exchange rate expands the policy space further because the government does not need to accumulate enough reserves to maintain a pegged exchange rate. On the contrary, a country with a non-sovereign currency does not have monetary sovereignty and faces a reduced policy space as it needs to borrow (to spend) internationally and thus is subject to market interest rates and risks of default.

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[10] Among new instruments that can be designed, an attractive one is a reserve requirement on foreign exchange *liabilities* of both financial and non-financial agents, which may substitute the traditional reserve requirement on capital *inflows*. This would also make this instrument more similar to traditional instruments of monetary and prudential regulation, which operate on stocks rather than flows."(Ocampo, 2011, p. 19).

[11] Camara Neto and Vernengo (2002) make the point that a higher interest rate, aiming at avoiding capital flight, will lead to higher interest payments on public debt and consequently, higher nominal deficits. The authors argue that when the public debt is indexed to the short-term interest rate, monetary policy translates into high debt servicing. This process has also an important distributive effect as debt holders are among the richest people and are those that benefit from higher interest rates paid on public debt at the expense of the less fortunate, who depend on public spending on social programs.

The exchange rate administration should result in a better current account, a steep reduction in foreign debt (Priewe, 2008), and in an improvement of the economy through an expansion of net exports, increased capital and R&D investments (Martins Neto and Porcile, 2017). This would increase stability, even though it would attract capital inflows, which would require appropriate measures to avoid an appreciation of the exchange rate. In this sense, this virtuous circle would increase foreign reserves, making speculations against the domestic currency progressively more difficult.

Lastly, and more importantly, macroeconomic policies demand an integration with the real economy. As Ocampo and Vos (2008) exemplify, fast-growing East Asian economies adopted macroeconomic policies as part of a broader development strategy, contributing directly to their long-term growth. Fiscal policies prioritised development spending, including investment in education, health and infrastructure as well as subsidies and credit guarantees for export industries. Further, monetary policy was coordinated with the financial sector and long-term industrial strategies, which included directed and subsidised credit schemes and managed interest rates to directly influence investment and saving, at the same time competitive exchange rates were considered essential to encourage exports. In this context, the political economy of policy coordination also matters, such as the role of interest groups and industrial elites in influencing long-term policy strategies.

Conclusion

Financially integrated developing economies face a hierarchical constrain within the global economy, particularly regarding their dependency on financial cycles posed by developed countries. This affects their monetary and fiscal options, as well as compromises long-term growth strategies by limiting the space of these economies to independently set their policy goals. Further, the benefits of the financial integration project posed by neoliberal

recommendations during the 1980s have not materialised as a sustained increase in growth and development levels, but rather as a volatility of macroeconomic prices for these newly open economies.

This article explored the main consequences of financial integration of developing economies and how it narrows their policy space to seek for long-term growth strategies. By pointing out three key characteristics of financially integrated DECs, we suggested how financialisation promotes a "policy lock-in" that increases interest rates, appreciates the exchange rate and affects the balance of payments. By assuming the increase on capital inflows as a result of financial integration, DECs present higher volatility on their macroeconomic prices – real exchange and interest rates –, which restricts domestic long-term decision-making possibilities.

Despite the vast literature listed in this article that demonstrates how these constrains occur within a financialised world, policy alternatives still deserve more attention from economists and decision-makers. We argue in favour of an increased policy space as a viable option for financially integrated developing economies in the sense of expanding their political and economic autonomy, which also implies tackling the hierarchy of financial power posed to these economies. Imposing prudential capital controls with restrictions to foreign borrowing are a necessary condition to macroeconomic stability, but such measure needs to be accompanied by consistent efforts to develop a coordination strategy between the real and the financial sector.

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