This is an Accepted Manuscript of an article published by Taylor & Francis in Economic and Political Studies on 05/02/17, available online: http://dx.doi.org/10.1080/20954816.2016.1274517

International financialization and the contradictions of privatized Keynesianism

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Short biographical note

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International financialization, developing countries and the contradictions of privatized Keynesianism

Abstract

This paper contributes to the understanding of the impact of international financialization on developing countries. It is generally understood that developing economies are part of the global financialization process, as exporters of goods to "debt-led" economies and as recipient of foreign capital inflows. This paper argues that a key process connecting these two aspects has been "privatized Keynesianism", the policy regime that sustained financialization in advanced economies, by promoting low interest rates and asset appreciation. A consequence of this regime is to induce pressure on global financial institutions to look for returns and profits in the developing world. Such a mechanism represents a fundamental connection between developing countries and financialization at the global level, beside the spread of financial liberalisation. In the post-crisis environment, this connection remains strong and has become even more dangerous for developing countries.

Keywords: financialization, privatized Keynesianism, financial crisis, developing countries

1. Introduction

Financialization is a global phenomenon. While most accounts of financialization focus on advanced economies, and the United States in particular, the growing role of finance in shaping economic and social relationship in developing countries is ever more evident. Even China, traditionally seen as an "exception" to the financialization process, has recently been experiencing troubles with its financial markets. In the context of peripheral countries, the recognition the international dimension of financialization is particularly important. As with their integration in the global economy, financialization in developing countries will be shaped by their subordinate position in the world[i]. Thereby, a central question about financialization, is what are the international channels through which it affects the developing world.

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The existing literature has focused on two main areas. One key focus have been the global current account imbalances and the resulting accumulation of foreign exchange reserves (Painceira 2009, Lucarelli 2012, Stockhammer 2012a). Under this approach, developing countries are primarily seen as exporters of goods and lenders to the core economies, chiefly the US, thus having a supporting role to financialization as a regime of accumulation centred on indebtedness (Stockhammer 2012a). Another key focus, which can be traced back to the financial crises in emerging economies in the late 90's, is the role of foreign financial institutions in generating financial instability (Arestis and Glickman 2002, Bibow 2008, Andrade and Prates 2013, Kaltenbrunner and Painceira 2015) as well as promoting domestic "financialization" (Lapavitsas 2009a, Gabor 2010, dos Santos 2011, Painceira 2012) in developing countries through capital flows and the direct investments to developing countries' financial sector. In this strand of the literature, developing countries experience their own form of financialization, but mostly in a position subordinate to foreign institutions decisions, following of the liberalization of their capital account.

This papers attempts to provide a synthesis between these strands, by exploring a further dimension of financialization that accounts for its expansion in developing countries. It focuses on the role of "privatized Keynesianism" (Crouch 2009, Bellofiore and Halevi 2012) as a policy regime to sustain aggregate demand in advanced economies and validating the accumulation of debt through asset price inflation, as well as increasingly delegate to financial markets welfare functions. Such a regime has been an essential component of financialization.

The key contention put forward is that a defining characteristic of this regime is the continuous need for monetary policy expansion. This is a contradiction of the policy regime, since, while sustaining asset appreciation and easing debt burdens, it reduces returns and

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profitability of financial institutions. The consequence of this contradiction is to push financial institutions to seek returns and profits in new markets. Capital flows and foreign banks entry - and the consequent expansion of financialization - into the developing world are therefore not only the consequence of financial liberalization policies and the speculative tendencies of financialization, but the result of the contradictory policy regime that sustains the finance-led regime of accumulation. The expansion of capital flows to developing countries since the crisis reveals how this mechanism is still at play, despite the end of the end of the "debt-led" growth regime that sustained global demand. The post-crisis financialization phase, devoid of its growth engine but still extending its geographical reach pushed by low interest rates and global liquidity, leaves the world economy in a very fragile state.

The paper is divided in four sections beside this introduction. In section two, the role of developing countries as exporters and receivers of capital flows in light of the standard theories of financialization is discussed. In section three, the role of "privatized Keynesianism" in driving capital flows to emerging markets in the pre-crisis financialized era is reviewed. In section four, it is argued that the post-crisis situation has put an end to financialization as a regime of accumulation, but "privatized Keynesianism" is still at the core of a global "search for yield", an increasingly dangerous situation for developing countries. The final section concludes.

2. Financialization and privatized Keynesianism and developing world: export-led

At a first glance, financialization describes the growing importance of finance for the key actors of capitalist economies, as well as society more broadly. Key defining stylized facts of financialized economies can in fact be understood by looking at the changes in macroeconomic sectors (Lapavitsas 2011, Stockhammer 2012b). Firms become less reliant on bank loans as a source of financing, relying instead more on market-based finance, and

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increasingly focus on short-term profit maximisation by investing in financial assets (Lazonick and O'Sullivan 2000, Orhangazi 2007). Households rely on credit to finance their consumption, in particular housing purchases, and financial income and capital gains to build-up their wealth (Langley 2006, 2008, Barba and Pivetti 2009, Foster and Magdoff 2009, Lapavitsas 2009b, Montgomerie 2009, Doling and Ronald 2010). In the financial sector, banks move away from lending primarily to corporations towards household lending and intermediation of financial securities and investment banking (Erturk and Solari 2007, Lapavitsas and dos Santos 2008, Lapavitsas 2009b), while non-bank financial institutions, form asset managers to hedge funds, grow exponentially, sparked by the privatization of pensions (Harmes 1998, Engelen 2003, Whalen 2012).

Together these stylized facts can be combined to define financialization and understand it as a regime of accumulation (Boyer 2000, Hein 2012, van der Zwan 2014). The political shift to neoliberalism, and the imperative of "shareholder value", resulted in declining investment and stagnating real wages. In these conditions, households make up for their non-growing wages with growing indebtedness, whose structure is rendered – seemingly – sustainable by the inflation of asset prices, most importantly housing. Households increasingly become net borrowers in the economy, and conversely firms become net lenders (deSouza and Epstein 2014). With growing financial asset markets, and demand for credit from the household sector, banks reshaped their business as household lenders and asset managers/financial asset intermediaries.

All in all, a financialized – or finance-led – regime of accumulation consisted in aggregate demand and economic growth in the US and other core economies being driven by debt and asset price inflation. Importantly, such engine also provided a source of growth for other nations at the global level, through exports. As (Bellofiore and Halevi 2010) put it, "the

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indebted consumer has been the main factor pulling the growth rate in the United States, while the latter has acted as the buyer of last resort for the neomercantilist economies". (Stockhammer 2012a) indeed argues that financialization, beside the "debt-led" growth model that corresponds to the description above, gave rise also to "export-led" growth models, whereby growth is fuelled by external demand through exports.

By and large developing countries play the role of exporters. Much of the developing world's growth since the 1990's – and especially in the 2000's – was linked to exports. There is in fact evidence that many emerging economies' growth regimes are profit-led through their export channel[ii] (Stockhammer and Onaran 2013). The developing world as a whole, as shown in Figure 1, has registered substantial current account surpluses since the turn of the century, at the same time when the US experienced substantial current account deficits. These dynamics strategies ultimately relied on "debt-led" economies as a source of global demand. As argued by Akyüz (2012, p. 12), "the rapid expansion of exports and growing current account surpluses of DEEs owe a great deal to US spending extravaganza". The link was direct for China, which registered substantial trade surpluses with the US in the mid 2000's. However, large parts of the developing world experienced the same patterns, either indirectly by exporting commodities to China or with the burgeoning outsourcing of Chinese production to neighboring countries (Akyüz, 2011; 2012; Lim, 2014).

Figure 1.

<<Figure 1 here>>

Source: IMF World Economic Indicators

Furthermore, these current account positions, by construction, imply net capital outflows from the developing world. Much of these capital outflows took the form foreign exchange reserves accumulation. Such accumulation by emerging and developing economies has been spectacular, reaching almost 6.5 US dollar trillions in 2014[iii]. Financial

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liberalization policies have made it possible for the US, so long as it maintains its role as a reserve currency – or as Marxist scholars put it "world money" (Painceira 2009) –, to finance its external deficits with capital inflows. This provides the key link between global imbalances and financialization:

> "In very stylized terms, the accumulation of private debt and the recurrent asset price booms and busts, which have characterized the neoliberal era, could only be sustained as long as U.S. dollar recycling from the surplus countries/regions continued unabated." (Lucarelli 2012)

In sum, the developing world contributes in promoting the financialization of "debt-led" economies, not only by exporting but also by financing their current account deficit.

There are however other ways in which financialization affects developing countries. Another element that Figure 1 reveals is that private capital inflows to the developing world have been positive. In fact, as shown in Figure 2, inflows have increased substantially since the mid-2000's and, since 2009, have recovered and outpaced the levels of the pre-crisis peak. Such increases are part of the process of financial globalization, which increasingly affects developing and emerging economies: total external assets and liabilities have substantially increased over-time reaching about 65% of GDP from 2007 onwards.

Figure 2.

<<Figure 2 here>>

Source: IMF Balance of payments statistics[iv].

The potentially disruptive consequences of financial globalization have been long recognised in a different strand of the literature on financialization. Currency and financial crises that ravaged the developing world in the late 90's as a result of volatile capital flows sparked by capital account liberalization have been subject to much analysis based on Minsky's financial instability hypothesis (Kregel 1998, Arestis and Glickman 2002, Frenkel and Rapetti 2009). More recently, the external financial vulnerabilities of the developing world have been linked to the fundamentally hierarchical nature of the global financial and currency system (Andrade and Prates 2013, Kaltenbrunner 2015), which once again favours the accumulation of foreign exchange reserves as a mechanism of protection against the instability of capital flows (Lapavitsas 2009a, Painceira 2009).

Financialization in this light is very closely related to financial globalization and the boom-bust cycles of capital flows to developing countries. Capital account liberalization and the emergence of international investors with short-term oriented outlooks characterise this aspect of international financialization. The developing world's exposure to financialization originates from their increasing vulnerability to the decisions of foreign investors, whose motives are largely unrelated to domestic fundamentals, and have destabilising impacts on financial and currency markets (Kaltenbrunner 2010, Kaltenbrunner and Painceira 2015).

These two strands of the literature analyse crucial aspects of the international dimensions of financialization and its impact on developing countries. The first strand of the literature highlights the role of financialization as a regime of accumulation at the global level, centred on the growing indebtedness by a number of advanced countries, chiefly the US, and the role of developing countries as exporters and net purchasers of advanced countries financial assets. However, the picture remains incomplete as it reveals little about how financialization is transmitted to developing countries – or, as (Lapavitsas 2009a) puts it, how it "embroils" them. There is no structural role for capital flows *to* developing countries, beside a reference to the financial crises of the late 1990s. Partially this is due to an excessive focus on *net* capital flows as a mirror image of current accounts[v]: the "uphill" flows of capital emerging from the current account surpluses in developing countries masks the equally sizeable *gross* financial flows "downhill" from advanced countries to developing countries.

The literature on capital flows and financial globalization in developing countries describes instead how international financialization has a direct impact on the developing world, driven by the increasing presence of foreign financial investors. However, this literature does not attempt to clearly link these phenomena to the characteristics of financialization in advanced economies, beside the increasing emphasis on short-termism or capital account liberalization. The next section attempts to provide a link between these two aspects, by focusing on the policy regime that sustained financialization: "privatized Keynesianism".

3. The contradictions of privatized Keynesianism: capital flows and the need for returns

Finance-led capitalism, as discussed, is centred on rising amounts of indebtedness to sustain aggregate demand and growth. In turn, such indebtedness "requires asset price appreciation to validate it" (Wray 2009). As a large proportion of new debts goes directly to bid up asset prices – e.g. mortgages reinforce housing appreciation -, it is clear how a "virtuous" cycle between debt and asset prices can sustain the economy.

These shifts were not however purely the result of "free-market" forces. A key element in the resilience of this system, was the increasingly active role of policy makers in shaping the economy and society through financial markets. The policy regime that supported the finance-led regime of accumulation has been termed "privatized Keynesianism" (Crouch 2009, Hay 2011, Bellofiore and Halevi 2012). Rather than trying to guide the economy through direct intervention, governments relied indirectly through the financial markets on private agents.

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A first element of this has been the increasing role of financial markets as providers of "welfare", and therefore influence in people's daily lives. Many areas, hitherto managed by the State, have been delegated to the financial markets: state spending per university student has declined substantially in real terms between the 1980's and the turn of the century[vi], while tuition fees have been introduced and gradually increased, leading to an explosion of student debt; public pensions have been declining across European countries, with private funded pensions schemes being promoted and developed (Churchill 2013). Finance breached into ever more aspects of society, which slowly favored the growing cultural acceptance of financialization, amidst the decline of traditional welfare systems (Cutler and Waine 2001, Langley 2006, 2008, Erturk *et al.* 2007 Doling and Ronald 2010, Schelkle 2012).

A second element of "privatised Keynesianism" is the use of macroeconomic policy to support financialization. Since the system as a whole, both in terms of aggregate demand and in its social policy content, is effectively dependent on ever rising asset prices, "a reduction in the price of houses would be seen as a disaster (as it would undermine confidence in debt), and governments would be expected to act through fiscal or other measures to get prices rising again" (Crouch 2009). Primarily, this is achieved through monetary policy. Since, the advent of the "Greenspan's put" in 1987, monetary authorities have reacted to financial dynamics by easing liquidity provision and lowering interest rates in case of severe declines in asset prices (Vercelli 2010). Lower interest rates and abundant liquidity make sure that credit keeps flowing on a steady upward trajectory of asset prices.

The combination of these two aspects which form "privatized Keynesianism" can be seen clearly in the management of the housing markets as the engine of growth of the United Kingdom from the early 1990's till the global financial crisis:

> "it was the easy access to credit, much of it secured against a rising property market, that was its [the UK growth model] most basic precondition. This served to broaden access to

> – and to improve affordability within – the housing market, driving a developing house price bubble. Once inflated this was sustained and, increasingly, nurtured by interest rates that remained historically low throughout the boom." (Hay 2011)

"Privatized Keynesianism" is therefore fundamental to the creation and endurance of financialization. It shows how financialization in advanced economies has been the result of direct policy choices to create an "asset-based" welfare society, rather than the triumph of unfettered markets. It also shows that active macroeconomic policy is an essential component of financialization, as central banks' accommodative policy stance acted to fuel asset prices and ease debt burdens. It is not by coincidence that as a regime of accumulation, financialization started unravelling in 2007, after two years of rate hikes by the Federal Reserve.

While this policy regime, at least until its crisis in 2008, was instrumental to sustain financialization and therefore driving global growth, it had some inherent contradictions. Using monetary policy to fuel the asset-price/debt cycle is a double-edge sword. On the one hand, lower interest rates and rising asset prices alleviate debt burdens and generate financial returns, in the form of capital gains, for all investors. However, they also lower the base benchmark of all financial rates of return. In this sense the regime is contradictory, as by boosting financial returns in the short-run, it simultaneously decreases long-term rate of returns.

Low interest rates can have a negative impact on financial institutions. While they improve borrowers' credit-worthiness, they generate problems for banks, which see their margins and ultimately their profits erode. As Figure 3 shows, net interest margins of banks have been declining since the 1990's. Similarly, they create problems for institutional investors, which see their reliable investment income decline, and the present value of their liabilities soar[vii]. As Figure 4 shows, investment income of UK life-insurers, whether

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inclusive or exclusive of capital gains, has been declining over-time. While asset price inflation may partially counteract this erosion, the decline in interest rates and yields has a sizeable negative impact on banks and institutional investors. Furthermore, even if one does not believe in the efficiency of the markets in reflecting economic fundamentals, there are limits to the sustainability of continuous appreciation of financial assets, which end up in sudden and sharp reversal.

Figure 3.

<<Figure 3 here>>

Source: Federal Reserve Bank of St. Louis

Figure 4.

<<Figure 4 here>>

Source: Office for National Statistics

Overall, the resulting situation is one of increasing pressure on financial institutions. With “safe” returns in the form of interest income declining, they need to look for alternative sources to generate profits as well as facing their long-term commitments to the household sector in the case of pension funds and insurance companies.

Such pressure has been a key driving force for financial innovation. New market opportunities need to continuously be created in order for financial institutions to be able to make sufficiently high financial returns. Indeed the boom a the collateralized-debt obligation market can be explained at least partially by the large demand by investors for assets that yield sufficient returns (Goda *et al.* 2013, Lysandrou and Nesvetailova 2015).

The creation of new markets also takes the forms of the increasing geographical scope of financial investments. In particular, emerging markets, with their high growth rate and expanding consumer markets, reduced external indebtedness and high levels of foreign reserves, and increasingly liberalized economic and financial system, have presented since 2002 a very good investment opportunity. Portfolio investors looking for high-yield securities and banks looking for profitable lending opportunities extended their reach to the developing world, and as a result, all types of capital flows, as shown above in Figure 2, have increased.

This is the key channel through which financialization is "exported" to the developing world. The most evident aspect of this is the expansion of capital markets in these economies. Between 2003 and 2014 the size of the emerging market debt market more than quadrupled, from $4 trillion to $18 trillion, while stock market capitalisation tripled from $4 trillions to $12 trillions (IMF 2015). The expansion of these markets was greatly enhanced by the entry of foreign investors. As shown in Figure 5, portfolio holdings of EM assets by advanced countries increased five-fold from $400 billion to about $2.4 trillions between 2001 and 2014.

Figure 5.

<<Figure 5 here>>

Source: author's calculations based on IMF coordinated portfolio investment survey

A second aspect is the growth of some of the typical aspects of financialization in "debt-led" economies, primarily driven by foreign financial institutions. The presence of foreign financial institutions has indeed dramatically increased. Foreign-owned banks account for about 50% of domestic loans and deposits in developing countries (Claessens and van Horen 2011). There is evidence that such foreign-owned banks have been leading a re-orientation of the domestic banking sector towards higher credit to households and speculative activities, including carry-trade operations to exploit the interest rate differential between advanced and emerging economies (Gabor 2010, dos Santos 2011). Lending from abroad also increased substantially, quadrupling in the 2002-2008 period (McGuire and

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Tarashev 2008). Part of such lending has also been used by non-financial corporations in developing countries to engage in carry-trade operations (Demir 2007, Powell 2013).

A third aspect is that foreign financial institutions were key in transmitting the financial crisis to the developing world in 2008. The large presence of foreign portfolio investors “flying to safety” amidst the Lehmann Brothers collapse generated currency and asset price collapses across all emerging markets (Akyüz 2012b, Kaltenbrunner and Painceira 2015), and foreign banks were also at the forefront of capital retrenchment by cutting back on lending and unwinding carry trade operations (Cho 2010, Gabor 2010).

Most of these phenomena can be easily linked to the literature on boom-bust cycles, considered in the previous section. The key aspect highlighted here is that such cycles, and their consequences on the developing world, are not only the consequence of a build-up of confidence followed by panic, sparked by capital account liberalization. While the push for financial liberalization promoted by the IMF was an important attractor of foreign direct and portfolio investments, these are also the product of the contradictory nature of the policy regime that stands behind financialization in “debt-led” economies, i.e. “privatized Keynesianism”. Ample liquidity and low interest rates in advanced economies were instrumental to push financial institutions to spread their investments and expand credit across the globe[viii], thereby promoting financialization in developing countries. Financial globalization in this sense is as much sparked by capital account liberalization than it is a product of the “search for yield”, which is a to a large extent a consequence of “privatized Keynesianism”.

There is therefore a structural link between financialization as a regime of accumulation and financial globalization, beside financial liberalization. A policy regime based on low interest rates to sustain the economy, is also a regime that facilitates the ever-

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expanding scope and scale of financial markets for institutions in search for profitable venues. "Privatized Keynesianism" in advanced economies thus provides a link between the role of developing countries as exporters and as recipients of foreign investments. Moreover, the latter nurtures on the one hand the instabilities that are intrinsic to greater cross-border financial interconnectedness, and spreads financialization to the developing world.

4. The crisis of financialization and the fragility of the post-crisis environment

The crisis showed the unsustainability of financialization. A global growth regime the ever-rising debt and asset appreciation was ultimately showed to be unsustainable, and it was no coincidence that the crisis started in the mortgage market, one of the pivots of the system. At the same time, it was a crisis of those financial institutions that overreached their investments in the hope of obtaining higher returns. The mispricing of risk in the collateralized debt obligation market is well known (Wray 2009). Equally important is global retrenchment of capital flows given the interconnections that grew during the era of financial globalization, and suddenly collapsed. Global capital flows collapsed from $11.8 trillions in 2007 to $2.2 trillions in 2008 (Lund *et al.* 2013). It was a "fully-fledged crisis of financialized capitalism" (Lapavitsas 2009b).

There are indeed ample seems to indicate that the global regime of accumulation centred on US (and to an extent UK) debt-led consumer has been seriously damaged. According to OECD data[ix], household indebtedness has been falling as a proportion of income: in the US and in the UK from a peak in 2007 at respectively 153% and 183%, it fell to 113% and 155% in 2014. House prices remain are still below their pre-crisis peak (Figure 6) and households net saving have sharply bounced back to positive since the crisis, although in the UK they have become negative again in 2013 (Figure 7).

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Figure 6.

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Source: OECD

Figure 7.

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Source: OECD

Without their ultimate source of spending, advanced economies have entered a phase of stagnation. In OECD countries, growth rates have been declining on average, never reaching 2% since 2008. Real investment, in absolute monetary terms, has only recovered to its pre-crisis level in 2014[x]. The response by governments has further added to deficient aggregate demand by pursuing austerity policies. There is ample evidence that austerity had a substantial negative impact on growth, especially in those countries already facing a recession (Guajardo *et al.* 2014, Jordà and Taylor 2016)[xi].

The policy reactions to the crisis, as “technically” innovative as they were, did not however a signal a substantial break with the policy regime of the past, indicating instead a commitment to “privatized Keynesianism” on an even grander scale. The response of monetary authorities was to slash interest rates to little more than 0%, and inundate the financial markets with liquid assets, in the hope of revamping asset prices and credit. The scale of such operations was unprecedented: between 2008 and 2014 advanced countries’ central banks purchased assets worth about $6.4 trillions, to which the ECB is expected to add approximately €1.1 trillions between January 2015 and September 2016 (BIS 2015, p. 85). Amongst the stated goals of quantitative easing policies was the explicit objective to increase asset prices and depress yields, and similarly easing the conditions for banks to

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extend more credit. And indeed, to this extent these policies were successful. Stock markets recovered quickly, and bond yields fell across the board, and evidence suggests that quantitative easing had a non-negligible role in this (Ehrmann and Fratzscher 2009, Martin and Milas 2012). Nevertheless, as shown, this was not sufficient to revamp the indebtedness cycle, let alone reviving the real economy in a meaningful way.

These policies however exacerbated even further the contradictory effects of "privatized Keynesianism". With interest rates and yields falling to record low, the pressure to generate higher returns is even bigger than in the pre-crisis period. Financial institutions have been "searching for yield" even more aggressively, taking on as much risk as regulations allow in the hope of a higher return.

This sparked a recovery of capital flows to emerging and developing countries. There is evidence that such recovery has been driven to a non-negligible extent by expansive monetary policy (Cho and Rhee 2014, Barroso *et al.* 2015). The penetration of foreign investors grew beyond that of the pre-crisis period, with foreign investors holding about 30% of emerging and developing countries government debt by the end of 2014, up from 20% at the end of 2008[xii]. Their geographical reach of such has extended to even more remote parts of the market: African sovereign bond markets expanded from $1 billion to $18 billions between 2008 and 2014; emerging markets private capital funds raised $226 billions between 2008 and 2014, increasing their share of total global private equity fundraising from 12% to 13%[xiii]. Unsurprisingly, capital markets in emerging economies recovered quickly after the crisis. Emerging markets bond capitalisation roughly doubled from $7.5 trillions to about $15 trillions[xiv].

Such developments present severe challenges for emerging markets. The pace and scale of this renewed wave of capital flows has created substantial pressures on emerging markets. Many emerging markets saw their currency initially appreciate substantially in the first years since the crisis. In 2010, Guido Mantega, the Brazilian finance minister, warned that the ultra-expansionary monetary policy in the US was generating a currency war, as countries sought to avoid appreciation against a devaluing dollar (Wolf 2010). Whether or not this was a “beggar thy neighbour” policy, as implied by Mantega’s comment, it certainly constrained the policy space of emerging economies. To avoid excessive appreciation, many emerging markets central banks’ deviated substantially from pure inflation-targeting regime, lowering interest rates well below their Taylor-rule consistent levels (Hofmann and Bogdanova 2012).

Beside currency issues, capital flows have generated concerns for financial stability. The longer and larger the boom in capital flows, the more serious the damage of a potential future reversal of such flows, with an all-too-familiar collapse in domestic financial markets. As a result, capital controls have been back on the agenda. The IMF, a long-standing proponent of full capital account liberalization, recognised the issue opened the way for the usage of capital controls, at least as last resort option (Ostry *et al.* 2011). And indeed, several emerging markets adopted various forms of capital account management techniques (Fritz and Prates 2014).

The threat of sudden reversals remains nonetheless high. The announcement of a possible “tapering” of quantitative easing policies in 2013, and the subsequent implementation at the end of the year, has had substantial negative impact on emerging financial markets. The reveals the unstable grounds upon which the recovery of capital flows and financial markets induced by the global “search for yield” has been built. Should the push of ultra-expansionary monetary policy disappear, so would much of investments by foreign institutions in the developing world.

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Unlike the pre-crisis period however, these inflows have come in an environment of declining growth for developing countries. The end of the “debt-led” boom in advanced countries implied a crisis of export-led growth strategies that relied on it directly or indirectly. Global imbalances have considerably shrunk since the crisis: according to OECD data the US deficits decreased from 5.3% of GDP to 1.1% of GDP between 2008 and 2015, while China’s surplus decreased from 9.2% of GDP in 2008 to 1.3% of GDP in 2014. Indeed there is evidence that global trade has structurally declined since the crisis (Hoekman 2015), with Chinese exports and imports declining, the latter being a prime cause of the decline in commodity prices that hit those countries reliant on commodity exports.

Absent the global source of demand that guided economic growth during the pre-crisis era, emerging economies had to resort to other policies. China resorted to economic stimulus in the 2009-2010 period, injecting just under $600 billions in the economy, 87% of which directed to infrastructural development, reconstruction and housing (Wong 2011). Although in smaller scale, many other emerging economies did resort to stimulus packages in the aftermath of the crisis, including Brazil, Turkey, South Africa and Indonesia and Russia, most of which, once again, consisted in infrastructural spending[xv]. While these measures were successful in obtaining a recovery, they were however not able to fully replace the global growth regime that was in place before 2008. In fact, economic growth in developing countries has slowed down: as a whole emerging and developing economies’ GDP grew by 5.4% on average in the 2010-2015 period, compared to an average of 7.1% in the 2002-2007 period[xvi].

With lower growth and shrinking external surpluses, borrowing from the developing world regained momentum. In key emerging economies, governments have registered stable or widening deficits since the implementation of the post-crisis fiscal stimulus (Source:

Economist Intelligence Unit). The corporate sector has also borrowed substantially, particularly through bond issuance: "Financial corporate issuance has risen from less than $400 billion per year to nearly $1 trillion. Meanwhile, non-financial corporate issuance has roughly doubled, reaching $400 billion by the end of last year" (Acharya *et al.* 2015). Despite the economic growth decline, domestic credit kept growing at roughly 12% per year in the post-crisis period (BIS 2015). As a result the corporate debt to GDP increased from 50% to 75% (IMF 2015).

Part of this increasing indebtedness is a "natural" consequence of the end of the "export-led" growth model. With smaller current account surpluses, the domestic sector necessarily sees net lending/borrowing position deteriorate. Accommodative fiscal policy in this sense has eased the burden of the external adjustment. At the same time, it reflects domestic private actors taking advantage of the very low borrowing costs. Global conditions seem to be a major determinant of the increasing corporate borrowing in emerging economies, and there is evidence that part of this borrowing is used to increase cash holdings or engage in carry-trade speculative activities rather than financing real investment (Bruno and Shin 2015, Caballero *et al.* 2015).

Regardless of its causes, the increasing indebtedness is increasing the external vulnerability of emerging economies. As discussed, a defining feature of the pre-crisis was the accumulation of foreign exchange reserves, which can act as a buffer of safety for emerging economies in case of external pressures. In the post-crisis era however, as Figure 8 shows, the ratio of reserves to debt, total foreign liabilities, and GDP have been declining. Furthermore, the sensitivity of local interest rates and yields to global conditions has greatly increased, so that debt burdens are themselves more volatile and contingent on foreign conditions (BIS 2015, p. 85).

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Figure 8.

<<Figure 8 here>>

Source: Author's calculations based on IMF balance of payments statistics and (Lane and Milesi-Ferretti 2007)

In sum, the consequences of "private Keynesianism" have created an even more unstable situation for emerging markets in the post-crisis environment. The ultra-expansionary monetary policies that followed the global financial crisis have not managed to revamp the "debt-led" consumption boom of the pre-crisis era. They have however led to increasing financial flows to the developing world, reflecting both the global "search for yield" by advanced countries' financial institutions but also the growing willingness of actors in emerging markets to borrow internationally. As a result, the position of developing countries position looks increasingly fragile: low interest rates are sustaining a boom in emerging debt markets, but in conditions of low global growth this may prove difficult to sustain. Deprived of its major mechanism to sustain global demand, financialization in the post-crisis era is a much less successful regime of accumulation, and may be spreading to the seeds of a new financial crisis across the developing world.

5. Conclusions

Global financialization for developing countries signified both a reliance on export-led growth and expanding financial markets. The link between these two aspects is "privatized Keynesianism", the policy regime that sought to sustain financialization as a regime of accumulation, through rising asset prices and indebtedness and a delegation of the welfare state to financial markets. Lowering interest rates and boosting asset prices pushed foreign financial institutions in search for return and profit opportunities to the developing

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world. The impulse generated by foreign capital was key in determining some "financialized" practices in developing countries.

In the post-crisis environment, the first of these two aspects has disappeared, as "debt-led" growth regimes collapsed. But the policy efforts to revive them have nonetheless kept the second aspect alive, and the "search for yield" has been in full power since 2009. This is generating some troubles in developing countries, as with lower growth, the sustainability of the increasing external indebtedness – which increasingly involves the private sector – can be put into question.

Looking forward, this poses two sorts of challenges. The first is to avoid that the current boom in capital flows results in a financial crisis in the developing world. While controls in capital movements may help, it is important to tackle the ultimate causes of the issue, i.e. the role of "privatized Keynesianism" in promoting the global "search for yield". That includes a rethinking of monetary policy, but also those policies centred on the promotion of "asset-based" welfare. The second, even greater, challenge is to find an alternative to financialization as engine of growth. As Hay (2011) argued "the Anglo-liberal growth model is broken and we lack a perceived alternative". If we are to avoid recurring financial crises there is however an urgent need to find such an alternative.

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[i] See e.g. Powell (2013)
[ii] I.e. their growth rate increases as the profit share of income distribution increases, due to the positive effect on net exports.
[iii] Source: IMF balance of payments' statistics.
[iv] Emerging markets included are: Argentina, Brazil, Chile, China, Colombia, Czech Republic, India, Indonesia, Korea (Rep. of), Malaysia, Mexico, Philippines, Peru, Poland, Russia, South Africa, Thailand, Turkey
[v] See (Borio and Disyatat 2011) for a thorough critique of current accounts as an explanatory factor for capital flows.
[vi] In the UK, from £8,000 in the mid 1980's to £4,850, as reported by (Dearden *et al.* 2011)
[vii] Liabilities of institutional investors, when measured at market consistent valuations, vary inversely with current interest rates.
[viii] (Ciarlone *et al.* 2009) for more recent per-crisis evidence on how "search for yield" behaviour of this kind compressed emerging markets bond spreads.
[ix] https://data.oecd.org/hha/household-debt.htm
[x] Source: OECD

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[xi] Unsurprisingly, in the US, where austerity policies were never really adopted, the recovery from the crisis has been quicker, as opposed to European countries.
[xii] Source: database by (Arslanalp and Tsuda 2012)
[xiii] Source: Emerging markets private equity association
[xiv] Source: BIS
[xv] See (ILO 2012) for an overview.
[xvi] Source: IMF World Economic Outlook