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ESRC GPID Research Network Briefing Paper 14

HAS INTENSIFYING FINANCIALISATION OF EMERGING ECONOMIES HELPED ACCELERATE PREMATURE DEINDUSTRIALISATION?

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Date: 23 July 2018

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SUMMARY

Emerging and developing economies no longer appear to be relying on the expansion of a vibrant manufacturing sector to generate economic development. This briefing paper highlights the need to investigate the possible role that increasing financialisation—both of the global economy and major emerging economies—could have recently played in fostering a trend of 'premature deindustrialisation'.

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About the GPID research network:

The ESRC Global Poverty and Inequality Dynamics (GPID) research network is an international network of academics, civil society organisations, and policymakers. It was launched in 2017 and is funded by the ESRC's Global Challenges Research Fund.

The objective of the ESRC GPID Research Network is to build a new research programme that focuses on the relationship between structural change and inclusive growth.

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THE DEVELOPER'S DILEMMA

The ESRC Global Poverty and Inequality Dynamics (GPID) research network is concerned with what we have called 'the developer's dilemma'.

This dilemma is a trade-off between two objectives that developing countries are pursuing. Specifically:

1. Economic development via structural transformation and productivity growth based on the intra- and inter-sectoral reallocation of economic activity.
2. Inclusive growth which is typically defined as broad-based economic growth benefiting the poorer in society in particular.

Structural transformation, the former has been thought to push up inequality. Whereas the latter, inclusive growth implies a need for steady or even falling inequality to spread the benefits of growth widely. The 'developer's dilemma' is thus a distribution tension at the heart of economic development.

Introduction

Dani Rodrik's seminal 2015 paper focused on the issue of 'Premature Deindustrialisation'. This term signifies that since the rise of the East Asian economies, other emerging and developing economies no longer appear to be relying on the expansion of a vibrant manufacturing sector to generate economic development. In his article, Rodrik traced this phenomenon to factors such as trade liberalisation and the rapid growth of a globally competitive manufacturing sector in China.

Sumner (2017) highlighted why 'premature deindustrialisation' matters. Drawing on Nicholas Kaldor (1967), Sumner emphasises the point that developed economies relied historically on industrial development, specifically the rise of the manufacturing sector, to enhance their technological development and labour productivity, and thus their living standards

This Briefing Paper highlights the need to investigate the possible role that increasing financialisation—both of the global Economy and major emerging economies—could have recently played in fostering premature deindustrialisation.

For example, Jump and McKinley (2016) investigated the consequences for Brazil and Indonesia of growing financial imbalances in the global economy.

Financialisation in Brazil and Indonesia

Brazil and Indonesia are economies that have been heavily influenced by international financial flows. For example, during the period 2005-2015 the net external asset position of both economies averaged over negative 30% of their GDP. This position was much more negative than that of other major Emerging Economies (see Table 1).

This statistic signifies that far more financial flows were coming into these economies than flowing out of them. This might, at first glance, appear to be an advantage for both economies. But this conclusion would depend on the type of financial inflows.

In fact, these inflows have been increasingly dominated by portfolio investment and the residual category of 'Other Investment'—not Foreign Direct Investment (FDI). These prior two categories include the most transient, unstable and unpredictable types of international financing.

Table 1. Average Net External Assets

for Major Emerging Economies (2005-2015)

(% of GDP)

The Economy	Average Net External Assets (% of GDP)
Brazil	-31%
China	+31%
India	-8%
Indonesia	-37%
Russia	+13%
South Africa	-6%

Source: Jump and McKinley (2016)

So, in response, both countries have had to purchase sizeable stockpiles of foreign-exchange reserves in order to respond to any resulting financial risk. Such reserves help offset the threat of a rapid stampede of such financial flows out of the economy. Such an outflow often happens at the slightest hint of domestic economic problems (or even unrelated economic events abroad). At the very least, such a rapid outflow would swiftly undercut the value of these major economies' exchange rate.

At the global level, there is a resultant process of unequal exchange at work. Namely, the inflows of unstable financial capital into Brazil and Indonesia have been motivated by the capture of high rates of return on short-term financial assets. Meanwhile, the central banks of both countries are obliged, as a protective measure, to purchase highly liquid foreign-exchange reserves (such as US or UK government bonds). But these assets have relatively low rates of return.

What is important to emphasise, in this context, is that there will also likely be telling adverse

domestic economic consequences for both Brazil and Indonesia from engaging in such international transactions. Kaltenbrunner and Painceira (2016) try to probe deeply into this phenomenon for Brazil.

Financialisation of the Domestic Economy

Kaltenbrunner and Painceira (2016) highlight the role of domestic central banks in trying to 'mop up' the excessive liquidity in the economy generated by the potentially lavish (but unpredictable and unreliable) inflow of foreign portfolio investment and 'other investment'. The central banks are constantly worried about the short-term macroeconomic effects of such rapid monetary expansion.

This 'mopping up' of externally generated liquidity has involved the deployment of Repurchase Agreements (Repos) by central banks. These transactions have involved trading domestic public debt securities with domestic banks in order to counteract the potential destabilising effect of erratic, short-term foreign investment. Kaltenbrunner and Painceira (2016) are able to document, for example, the dramatic rise in the value of Repos in Brazil between 2004 and 2014. This value skyrocketed from RS$58 billion to RS$858 billion.

The ensuing increased holdings of domestic public securities allowed Brazilian banks to expand their own portfolio of loans. However, these loans had to be short-term in nature as well, in order to accord with their correspondingly short-term public assets. Thus, banks began to expand their short-term lending to households, rather than provide longer-term lending to nonfinancial corporations. The resulting loans were often used primarily to expand domestic consumption.

This short-term bias implied that longer-term lending by banks to corporations in order to finance productive investment was being increasingly displaced. In other words, the originating inflows of short-term financial assets were leading, in turn, to short-term lending by domestic banks. Financing for Brazilian industry—and manufacturing in particular—was being correspondingly 'short-changed'.

Thus, while it might be argued that financialisation of the global economy and its intensifying influence on major emerging economies such as Brazil and Indonesia have not been the 'driving force' of their premature deindustrialisation, it is certainly likely to be an important contributing factor.

Conclusions

A future research focus on premature deindustrialisation would benefit from examining more closely and critically the complex phenomenon of financialisation as a potentially important contributing factor.

References

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