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# Financing Economic Development. Theoretical Debates and Empirical Trends

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## **Abstract**

This Working Paper is a contribution to Task 2 of Work Pack 6 Finance, Development and Global Governance. Task 2 seeks to assess the impact of the changes in the global financial and monetary system on developing countries. Within Task 2, the research is concerned with the effect of the evolution of the international financial and monetary system on developing countries since the financial crisis, and how this impact is affecting the modalities of co-operation among developing countries, multilateral trade and development agencies and the governments of OECD countries and the EU. Deliverable D6.06 has been structured as a series of working papers (Working Paper 139; Working Paper 140 and Working Paper 157). These report on the implications of various changes in the relations between the developed world, including the EU, and the developing world for financing development of developing countries, against the backdrop of transformations entailed through financialisation and the global financial and economic crisis. In essence, two broad themes are explored. On the one hand, there is a focus on changes in the nature of development cooperation over the last decade, including qualitative changes bearing on the increased prevalence of Official Development Assistance (ODA) to promote private flows. On the other, the implications of the increased importance of domestic mobilisation of resources for financing development are considered. This Working Paper places these specific themes in the broader context of conceptual and empirical issues bearing on financing development.

Key words: development finance, financial flows, domestic resource mobilization, global financial crisis.

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## 1 Introduction

Growth rates worldwide have diverged widely (see Tyson and McKinley 2014). Some countries have emerged as important global players while others remain marginalised with large parts of their population persistently living in poverty. Tyson and McKinley (2014) highlight that while a number of macroeconomic and structural variables account for this diverging experience, a “consistent theme” has recurred in relation to the financial sector. This relates to the ability of countries to mobilise resources for investment (through boosting savings rates and/or attracting foreign capital to investment) towards “pro-development” activities including those that boost agricultural productivity and foster industrialisation. Investment rates have indeed diverged significantly across the developing world, where East Asia and the Pacific region have been leading with investment rates in excess of 35 percent of GDP since the mid-2000s (see Tyson and McKinley 2014, figure 6).

This Working Paper is part of Deliverable 6.06 and surveys theoretical and empirical trends bearing on financing development. It proceeds as follows. First, it explores the conceptual issues bearing on the financing of development through the lens of the history of economic thought. This is followed, second, by a review of main trends in external development finance since the 1980s. This draws attention to the accelerated financial integration of the developing countries that has taken place since the turn of the Millennium and which has continued apace since the global financial and economic crisis (with a brief momentary pause at the outbreak of the crisis), the lacklustre commitment to Official Development Assistance (ODA) on behalf of traditional (Northern) donors, and the rise of alternative actors on the scene of development finance, including through the BRICs. The third section documents the changing nature of domestic resource mobilisation over the last few decades, with its own possibilities for financing development against the background of the hazards of accelerated international financial integration.

## **2 Financing economic development. A theoretical overview of insights from the old to the newest development economics by way of the GFC**

Key to any development strategy is how to finance domestic investment (and accelerations of investment rates). In a review of conceptual issues bearing on financing development, De Carvalho (2009) highlights how the question of financing development has been “surrounded by conceptual and analytical inconsistencies”. The author sets out to clear some of these. He does so by exploring various dimensions or “meanings” attached to the term “financing”, including a real side, a fiscal dimension, a balance-of-payments (or foreign currency) dimension and a “financial dimension proper”. These dimensions capture various issues bearing on the scope for raising investment rates in an economy. These include: the level (and distribution) of national production, the nature of state intervention (and its underlying interests), the internationally integrated nature of an economy and the crucial role of finance. These dimensions highlight the importance of various (but interlinked) issues for the question of financing development. First, the role of finance will be determined by its relations to the state as well as the nature of the financial integration of the domestic economy internationally and its relations to other sectors of the domestic economy (the “real” side of the economy). Second, the scope for fiscal mobilisations to finance development will hinge on the nature and the strength of the financial sector vis-à-vis other sector as well as, again, its broader articulation with international forces and with the state. Third, the implications of the international integration of the economy through trade and financial flows, both official and commercial, for the scope to accelerate the investment rate, will depend on the possibilities of the state to direct foreign exchange to particular sectors as well as to steer the role of the domestic financial sector’s within this nexus. In most general terms, the scope for increasing the domestic investment rate depends on underlying interests acting both through the state and the market, the nature of the integration of the economy globally as well as the role of finance.

These issues had been extensively discussed in the debates of what is often referred to as the “old development economics”, with its interest in broader issues of structural transformation, historical trajectories, the role of institutions (including the state), distribution of resources,

the role of industry, relations between industry and agriculture, etc. In particular, with regard to finance, the interest was in:

“the role of the financial system in supporting structural transformation of an economy, from dominance of low productivity to high productivity sectors, with accompanying shifts in employment, the transformation of agriculture and the development of industry and trade” (Tyson and McKinley 2014, p. 3),

and in assessing the role of the state in this context, with specific concerns regarding the scope for a state-dominated financial sector to enable the allocation of resources strategically across the economy through directed credit, subsidised access to finance, etc. In a landmark contribution on the role of the financial system in development, Gerschenkron (1962), for instance, emphasised the role of a successful financial system to facilitate industrialisation in an attempt to overcome economic “backwardness”.<sup>i</sup>

De Carvalho (2009) sits, however, amongst a set of more recent contributions (see also Ghosh 2010; Aizenman, Pinto, and Radziwill 2007; Arestis and Resende 2015; te Velde and Griffith-Jones 2013) that seek to (re-)clarify underlying mechanisms bearing on financing development, despite decades of contributions to the topic.<sup>ii</sup> This need perhaps emerged as an attempt to overcome, or in response to, an ambiguous evidence base regarding the effect on growth rates, structural transformation, investment rates, inequality, etc. of much promoted policy prescriptions bearing on financial sector development, foreign investment, the capital account, broader financial and productive integration, etc. that had come to prevail from the 1980s onwards and which are anchored on a narrow understanding of the role of finance in development (see below). I.e. a strong disjunction between promoted policies bearing on the financial sector and the emerging evidence base may have prompted a renewed interest in understanding the implications of financial sector policies for development.

It was often argued, for instance, that growing financial integration internationally would allow the capital stock in developing countries to increase by making foreign savings available. The evidence, however, revealed a tendency for greater financial integration to allow for inflows of foreign savings to finance outflows of domestic savings, which little (or negative) net impact on

a country's financing ratios (Aizenman et al. 2007).<sup>iii</sup> On average, the “growth bonus” allegedly attached to increasing the financing share of domestic investment by foreign saving has not materialised. On the contrary, “countries with high self-financing ratios grew significantly faster than countries with low self-financing ratios” (ibid., p. 684), with the striking contrasts between the Asian region, on the one hand, and Latin America and Africa on the other. Lautier, Moreaub, and others (2012) further recast the link between foreign direct investment (FDI) and domestic investment, drawing on evidence that seems to indicate a reversal of the presumed causality between FDI and domestic accumulation rates. Instead of FDI increasing domestic investment (and hence growth), domestic investment rates drive FDI flows. Griffith-Jones and Karwowski (2013) illustrate how financial sector deepening has not promoted credit allocation to productive sectors in sub-Saharan Africa.<sup>iv</sup>

Underlying the policy prescriptions of liberalisation of the financial sector is a trajectory of analytical propositions on the role of finance in development that initially emerged during the 1970s. This would subsequently become attached to the “new” development economics that came to dominate development economics during the 1980s and which would itself subsequently be modified to accommodate its disjuncture with overwhelming and contradictory evidence (from Washington to post-Washington Consensus and beyond).<sup>v</sup> The original framework emphasized the function of finance as an intermediary between utility-maximizing savers and investors. Efficiency in this role was therefore paramount, and eliminating so-called “financial repression” became a central obsession (McKinnon 1973; Shaw 1973; Fry 1978).<sup>vi</sup> Increasing the size of the financial system relative to the economy (“financial deepening” measured as the increase in private sector credit as a share of GDP) was increasingly accepted as a *sine qua non* of economic growth. The special role of the banking system in determining the money supply was to be regulated by an independent central bank with inflation control as its sole objective (see Powell and Van Waeyenberge 2010; Bonizzi 2014).

The analytical framework of the McKinnon and Shaw model remained hampered by an underlying attachment to an intermediation of loanable funds model of banking (see Jakab and Kumhof 2015 for a recent critique). The classical dichotomy between real and monetary sectors is upheld, with interest rates mediating between real flows where savings enable

investment outlays. In essence, higher interest rates stimulate savings, which are channelled through the financial sector towards investments. The price in the market for loanable funds (the interest rate) acts as the most efficient mechanism through which to allocate resources for savings and investments (market-determined interest rates allow for efficient intermediation between savings and investments). There is also no interest in structural and/or institutional features (laws, regulations, customs) bearing on the financial system and their implications for its interactions with the real economy, as a main focus on interest rates prevails.

This framework, together with the particular policies that derive from it, was fundamentally flawed in its limited understanding of the role of the financial sector in the economy, with its projection of the interest rate as a real rather than a monetary phenomenon, and was also ill-suited to capture the realities of development and its financing (see Bonizzi 2014 for an overview of the main critiques). Apart from its failure to incorporate institutional and structural features bearing on the interactions between real and financial sectors, the framework is characterised by its incapacity to distinguish between financing which is “a cash-flow concept, [which] is access to purchasing power in the form of an accepted settlement medium (money), including through borrowing [credit]” and saving which is income (or output) not consumed (Borio and Disyatat 2011, p. 1). This relates to the failure of the underlying analytical framework to acknowledge the substantive implications of money (and credit) for economic analysis as the analysis remains driven by a form of “real analysis, better suited to barter economies with frictionless trades” (p. 2) (see also Arestis and Resende 2015).

As the disappointing results from financial liberalisation increasingly became evident, a reconsideration of the relationship between the financial system and (capitalist) development occurred. Aybar and Lapavistas (2001) distinguish two main research agenda emerging in response. On the one hand, there was a stream attached to the post-Washington Consensus which argued that bank-based financial systems that exercise state controls over financial prices and flows (i.e. that are “repressed”) tend to be more efficient at promoting economic development than liberalised market systems (Stiglitz and Weiss 1981; Stiglitz and Uy 1996). On the other, arguments were developed to buttress the proposition that liberalised and market-based financial system can be conducive to development (King and Levine 1992;



Demirguc-Kunt and Levine 1996), where attention is drawn to the complementary role of stock markets in a market-based banking system.

Aybar and Lapavitsas (2001) highlight the shared conceptual framework to these two streams. Both are reliant on the concept of asymmetric information and fail to understand the financial system “as an entity [a system] the various part of which are organically related to each other and to the ‘real’ economy”. Instead, the authors continue, “the financial system is treated as an agglomeration of institutions, markets and assets that might or might not exhibit certain informational properties” (p. 29). The aims of these two strands are to identify the type of financial system that has optimal informational and other characteristics for development of the “real” economy, with little attention to the two-way interactions between financial system and real sectors.

Various propositions emerge through specific attributions of information and/or behavioural characteristics to the different markets, instruments or assets that together constitute the financial system in these models. This includes, in the first strand which favours bank-based systems, drawing on principal-agent propositions to accommodate behaviour of market participants in the context of asymmetric information, where this may lead to adverse selection or moral hazard and where, as a consequence, unregulated banks may lead to inefficiently high interest rates, discourage productive investment or reduce returns to lenders by exposure to risky borrowers (i.e. the market works imperfectly). For bank-based supporters banks raise more stable, long-term capital (so-called “patient capital”), taking on the maturity mismatch themselves rather than passing it on to individual depositors. They are able to make strategic investments, and are able to discipline borrowers through direct oversight of their activities. Drawing extensively on the East and South East Asian experience (prior to the crisis of the late 1990s), “market-friendly” interventions, including through “mild” repression of interest rate and directed credit allocations, are favoured to promote savings, efficient resource allocation, accumulation of physical capital, etc (Stiglitz and Uy 1996).

For those supporting market-based financial systems, the focus shifts to financial development and stock exchange development as contributing factors to capital accumulation and growth (R. Levine and Zervos 1996). In response to an earlier (Washington Consensus-type) emphasis

on financial liberalisation, the argument now incorporates attention to the sequencing of financial reforms, where successful liberalisation “depends on the development of the stock markets to complement existing financial markets and intermediaries (Fry 1997)” (Aybar and Lapavitsas 2001, p. 33). In essence, this literature seeks to put forward the argument that financial development (with stock markets as an important part of the financial system) causes economic growth and development. Levine (1997) unpacks the ways in which finance promote development. These include: risk trading, resource allocation, monitoring, savings mobilisation and facilitation of the exchange process. The argument emerges for strong development and international integration of a country’s financial system, including of its stock market, which through its complementary function in mobilising financing, contributes to economic growth. Hence, for market-based advocates capital markets do a better job at mobilising savings, and providing risk management through portfolio diversification. Capital allocation benefits from the “wisdom of markets”, and borrowers are disciplined through shareholder activism and corporate takeovers.

Until the latest financial crisis, the market-based advocates dominated the debate. Both the advice and the explicit conditionality accompanying IFI lending supported the development of capital markets and the liberalisation of domestic banking (predominantly through foreign bank entry). For the advocates of a market-based financial system, the East Asian crisis of 1997-8, for instance, was conventionally understood as an indictment of the clientelism inherent in local bank-industry conglomerates, rather than a result of capital account liberalisation facilitating the speculative behaviour of footloose capital both domestic and international (see Powell and Van Waeyenberge 2010).

Various critiques emerged in response to such a favourable view of financial market development. This included the observation that stock markets in poorer countries tend to have low capitalisation, high volatility and heavy dependence on world markets, rendering these markets fragile with attendant risks for the entire financial system (Aybar and Lapavitsas 2001, p. 34). Further, international integration enables international capital flows directed at stock markets, increasing financial instability and renders the economy vulnerable to international macroeconomic fluctuations (see Singh 1992). See also Akyüz (1993) on the close link between capital and currency markets and the implications for stability.

Aybar and Lapavitsas (2001, p. 36) note that despite their differences, the two streams of the debate “regard the operations of the financial system as an effective cause of successful capitalist development”, where financial development drives economic growth. The debates are then about preferred institutional structure, determination of price and quantity of credit, etc. in enhancing the capacity of the financial system to support economic development. Such an approach however fails to appreciate the integrated nature of the financial system with a specific system of accumulation, where the nature of this integration is context-specific and determined by historical, institutional and social factors. I.e. the nature of a financial system reflects country-specific historical and social circumstances and these relate to, or emerge from, domestic and international realities (Aybar and Lapavitsas 2001). And while the newer development economics attached to the PWC tries to move away from some of the more extreme policy recommendations emerging from the WC, its analytical apparatus remains inappropriate to guide us in understanding the realities bearing on financing development as it fails to appreciate the intrinsic integrated nature of a financial and real system of accumulation.

The shock of the global financial crisis (GFC) and its continuing aftermath have rekindled an interest in the broader issues bearing on financing development, including in the repercussions for domestic resource mobilisation for growth and development of specific links between domestic economies, global trends and the world economy. The trends and dynamics leading up to the financial crisis, and that are often summed up with reference to “financialisation”, have had specific manifestations in developing country contexts with important implications for the relationship between the real and financial sector, the way in which the national economy is integrated internationally, the role of the state, and ultimately, the scope to finance development. Bonizzi (2014, pp. 18 - 25) provides a comprehensive overview of the literature on these issues. Powell (2013) has, for instance, drawn attention to the way in which “subordinate” financialisation characterising developing countries within a broader international context of unequal relationships facilitates disproportionate extraction of domestically generated surplus by foreign capital (quoted in Bonizzi 2014, p. 16). Other issues that have been raised include the negative implication of financialisation for non-financial firms’ investment, to the detriment of productive rather than financial investment; the increased emphasis on shareholder value, with negative implications for productive

investment or domestic resource mobilisation. Bonizzi (2014, p. 20) sums up how at the “macro-level the combined availability of high-return short-term financial investments and the pressure from financial investors [own: as specific manifestations of financialisation] have led ... to a reduction in productive investment (as a share of GDP) in many developing countries”. These trends and their effects have also tended to be accompanied by a re-orientation of bank credit in developing countries, towards credit provisioning for households rather than firms. Further, the role of banks (also in developing countries) has tended to change, as they have become increasingly engaged in different kinds of activities, including securitisation, asset trading and insurance, for fee and commission income, away from credit and intermediation activities. The role of foreign banks, which have expanded their activities rapidly in developing country markets, in the transmission of “financialised” practices has been highlighted (see dos Santos 2011, 2013 for the Philippines, Brasil and Mexico; Cho 2010 for Korea). Further, the expansion and financialisation of microfinance (increasingly linked to global capital markets) (see Tyson 2012) and the financialisation of the commodity markets, with implications for volatility of commodity prices (see Ghosh 2010) and the distribution of value along the production chain (Newman 2009), have received attention.

The renewed scholarship and broader interest prompted by financialisation and the GFC has hence spurred a set of questions being asked once again about the nature and purpose of financial systems. What types of activities should our financial systems foster? How large should they be? Who should control the institutions of our financial systems? Etc. A recent IMF Staff Discussion Note (Sahay et al. 2015, pp. 5-6) put this as follows:

The 2008 global financial crisis raised some legitimate questions about financial deepening and financial development, given that the crisis originated in advanced economies, where the financial sector had grown both very large and very complex. Are there limits to financial development for growth and stability? Is there a right pace of development? Are there tradeoffs? What is the role of institutions in promoting a safe financial system ... Does financial integration help or hurt economies?

These questions set the scene in Sahay et al. (2015) for a review of the evidence that has emerged over the last few years on the relationship between financial development and

growth. The IMF Discussion Note also proposes a new, more comprehensive indicator of financial development, the Financial Development index, to replace the ratio of private credit to GDP (sometimes augmented with stock market capitalization as a ratio of GDP), which has traditionally served as a measure of financial development. It is argued that the traditional indicators do not capture sufficiently well the various ways in which financial development can affect growth,<sup>vii</sup> as they fail to capture the diversity of financial systems across countries. The new measure (index) incorporates multiple indicators of financial development, including measures of financial depth, access and efficiency of financial institutions and markets (see Annex I of Sahay et al. 2015 on how the index is constructed). The index also reflects the reality that financial sectors have evolved over time to become complex systems that include a range of financial institutions (banks, investment banks, insurance companies, mutual funds, pension funds, venture capital firms and other nonbank financial institutions) and financial markets (including stock markets, private and public bond markets and foreign exchange markets).

Deploying this new index the Discussion Note proposes the following findings (Sahay et al. 2015). There is a positive relationship between financial development and growth (and stability). But, this relationship has a bell-like shape, i.e. there are trade-offs between financial development and growth and stability where at some point the costs outweigh the benefits. “In fact, there can be instances where there is ‘too much finance’” (p. 6). Further, the pace of financial development matters, where too fast a pace can cause instability. And, strong regulation and supervision of the financial sector is a condition for financial development to lead to growth rather than instability. Finally, “there is no one particular point of ‘too much finance’ that holds for all countries at all times” (p. 15). The shape and location of the bell-like curve depicting the relationship between finance and growth differs between countries and is affected by features such as income levels, institutional environment, regulatory and supervisory quality within the country, etc.

These findings follow on from earlier contributions, which had illustrated how the traditionally projected positive link between financial development and growth weakens when using post-1990 data. Barajas, Chami, and Yousefi (2013) highlight that the relationship between financial development and growth differs across regions, countries and income levels. Rousseau and Wachtel (2011) point to the increased incidence of banking crises in accounting for the

absence (or “disappearance”) of an empirical link between finance and growth. And Arcand, Berkes, and Panizza (2012) illustrate how there may be a point at which additional deepening start harming growth (the “too much finance” –effect).<sup>viii</sup> Different accounts have been provided for the weakening of the finance-growth relationship. Cecchetti and Kharroubi (2015) point to negative effects on allocative efficiency and crowding out of human capital away from real sectors towards the financial sector, as the latter expands rapidly. Dabla-Norris et al. (2015) also suggest that resources in advanced economies had been diverted away from productive sectors toward the financial sector in the period prior to the global financial crisis. Rajan (2005) draws attention to the scope for “catastrophic meltdown” when financial development leads to large and complicated financial systems.

Most recently, the OECD in a Report entitled “Finance and Inclusive Growth” (Hoeller, Denk, and Cournède 2015) has added its voice to demands for cautious assessments of rapid financial expansion. The Report argues, on the basis of an analysis of data spanning 50 years, that too much finance may hamper economic growth and may worsen income inequality. Yet, despite these various observations, the World Bank (2013, p. 32) in setting out its vision of Financing for Development post-2015 has persisted with the proposition that:

“Promoting financial deepening and inclusion could accelerate private-sector growth, an important driver for poverty reduction and fostering shared prosperity. Financial institutions facilitate economic growth by mobilizing savings and allocating these savings to the most productive investments. There exists a large body of evidence finding a strong, positive relationship between financial sector development and growth. A well-developed and inclusive financial system also has positive impacts on equality by providing poorer individuals with savings opportunities and much-needed credit. Without inclusive financial systems, poor people must rely on their own limited savings to invest in their education or become entrepreneurs—and small enterprises must rely on their limited earnings to pursue promising growth opportunities. This can contribute to persistent income inequality and slower economic growth”

Different policy directions clearly prevail across the world of international financial organisations and think tanks, where this quote from the World Bank indicates a persistent

unwillingness to question previously held ideas regarding financial development and growth. The Bank persists with an understanding of hurdles to growth and development entirely anchored in insufficient (private sector) financial development. A singular focus on lack of financial inclusion (i.e. broad access to financial services within the population) as cause of income inequality and slow economic growth transpires to the neglect of the broad set of non-financial factors, actors, institutions and linkages that bear on development outcomes. Plus ça change ...

These various propositions regarding finance and development, including the latter benign projection of the role of finance have coincided with a radical change in the international financial integration of developing countries with significant implications for the domestic financing landscape. The next sections document the empirical trends bearing on financing development, considering first external finance, including both private capital flows and Official Development Assistance, and then proceeds to discuss the crucial role played by domestic resource mobilisation.

### **3 Trends in External Financing for Development<sup>ix</sup>**

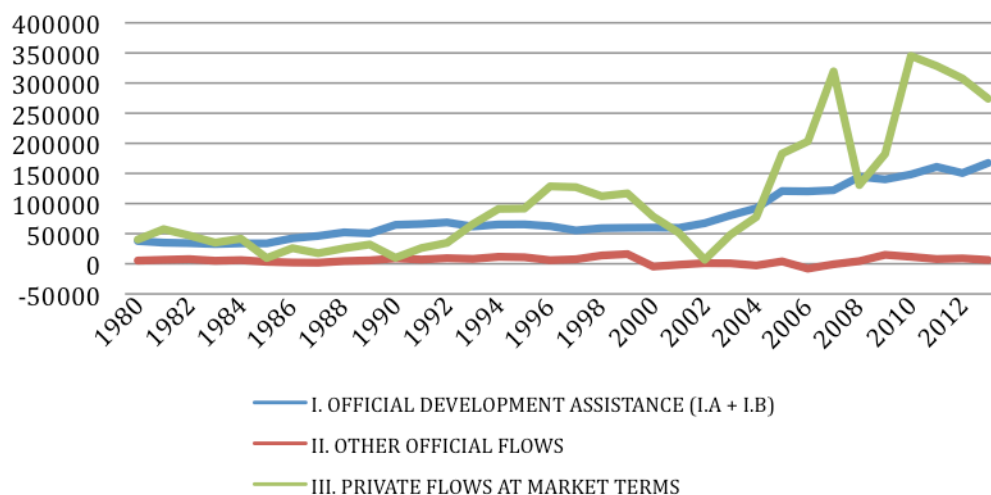
#### **3.1 ODA and other official flows**

It has already been asserted above that the mix of financial flows to developing countries has changed dramatically since the early 1990s. In the early 1990s, ODA was the largest external resource flow for almost 100 developing countries, while in 2011 it was the largest for 43 countries (Griffiths et al. 2014, p. 12).

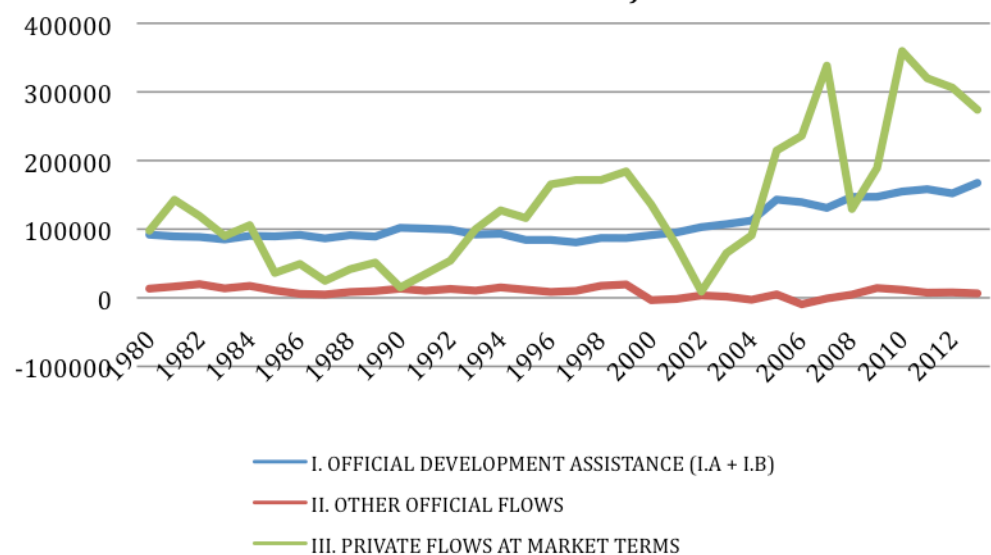
Figures 1 (a and b) and 2 chart the composition of foreign flows to all developing countries since 1980. Private flows have increased, both in absolute and relative importance compared to ODA and OOF for developing countries as a whole. Evidently, private flows are also more volatile, reducing dramatically, for example, immediate after the 2008 global financial crisis. ODA appears to have increased slowly in absolute terms but has stalled since 2010 (figures 1a and 1b).



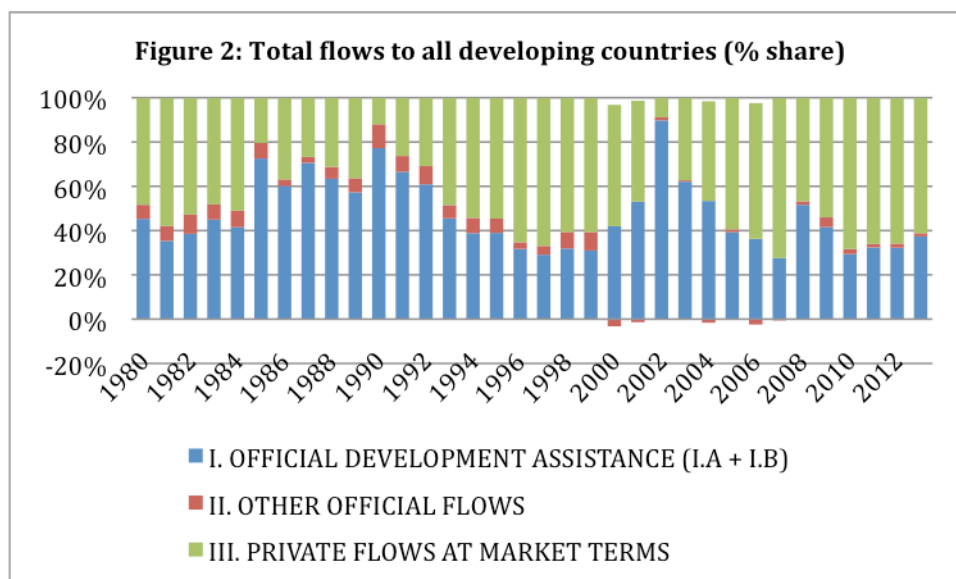
**Figure 1a Total flows to all developing countries (current USD millions)**



**Figure 1b Total flows to all developing countries (constant 2013 USD millions)**

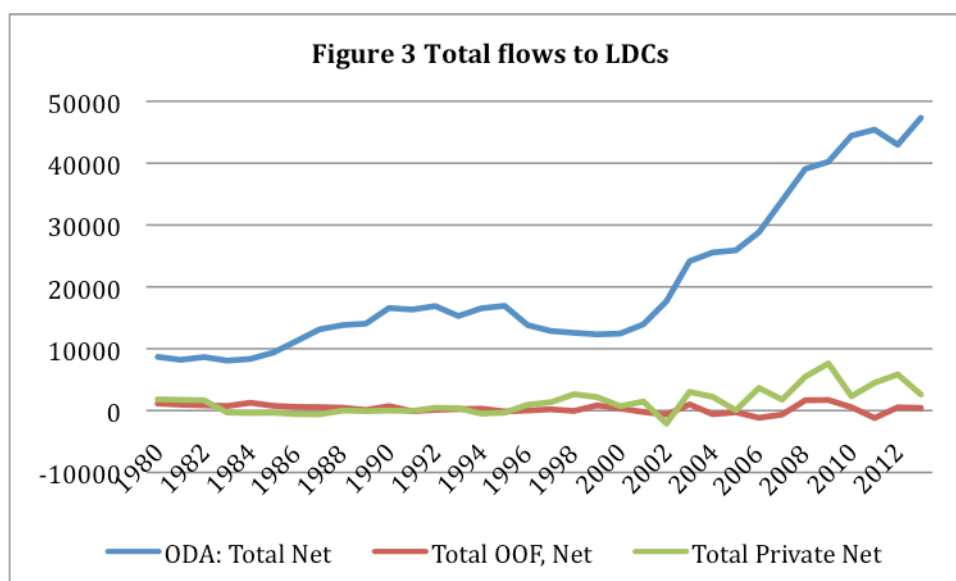




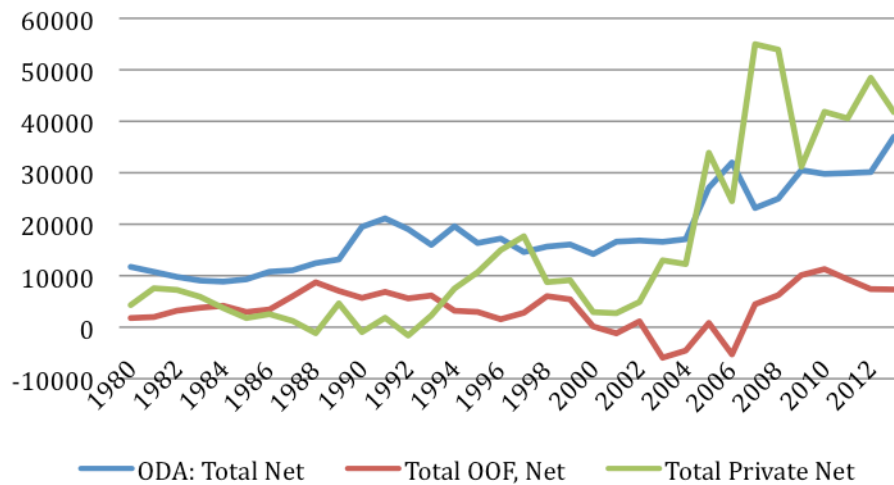


Source: OECD STAT online database

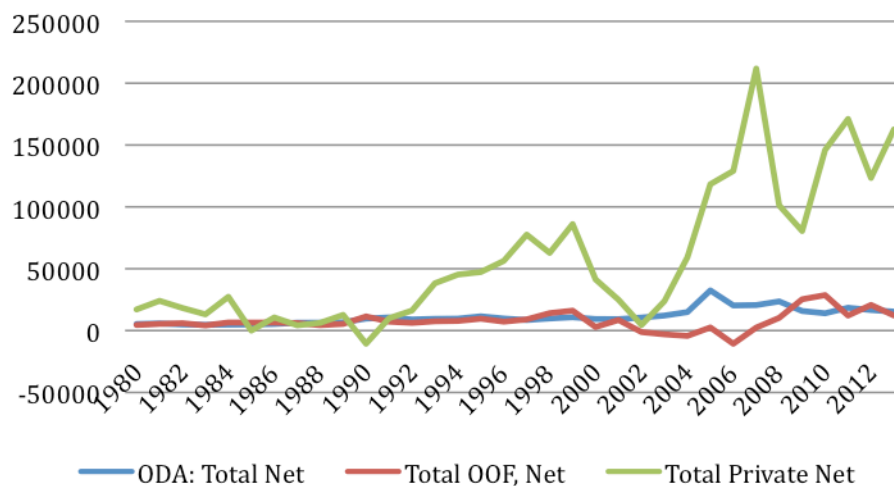
A breakdown of flows by country grouping is helpful in understanding the overall evolution of foreign flows to developing countries. Figures 3 to 5 shows this breakdown for LDCs, LMICs and UMICs. For LDCs, ODA flows continue to dominate over private and OOF. However, for LMICs the picture is less clear, with private flows having overtaken ODA for most years since 2005. OOF are also higher in LMICs than in LDCs. Finally, in UMICs it is clear that private flows dominate the picture, although once again the volatility of such flows is evident in figure 5.



**Figure 4 Total Flows to LMICs**



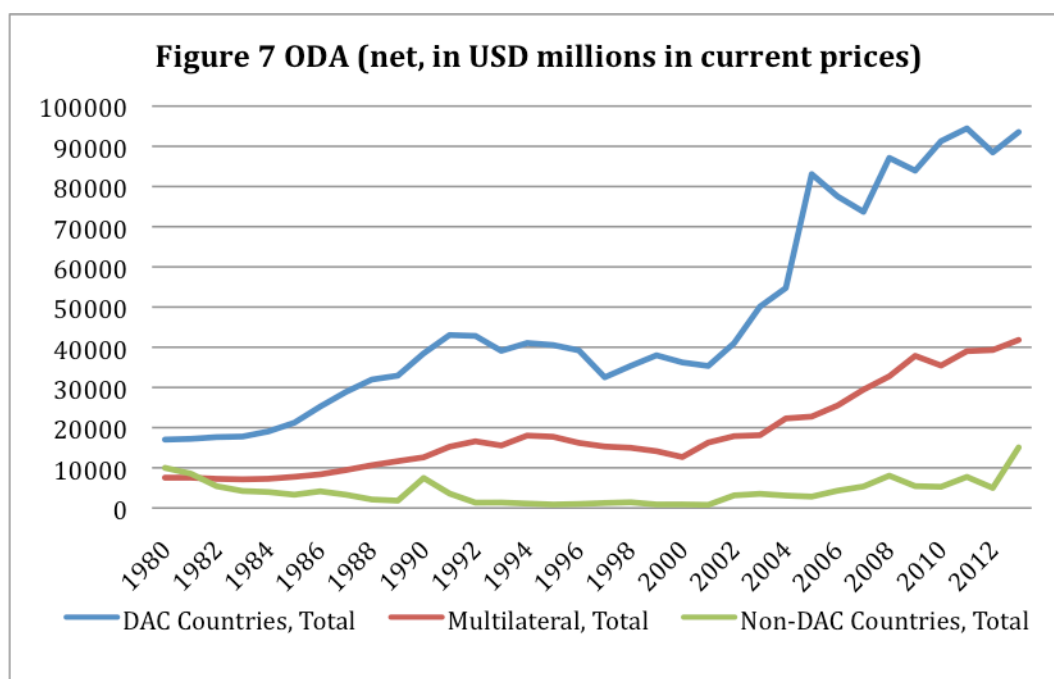
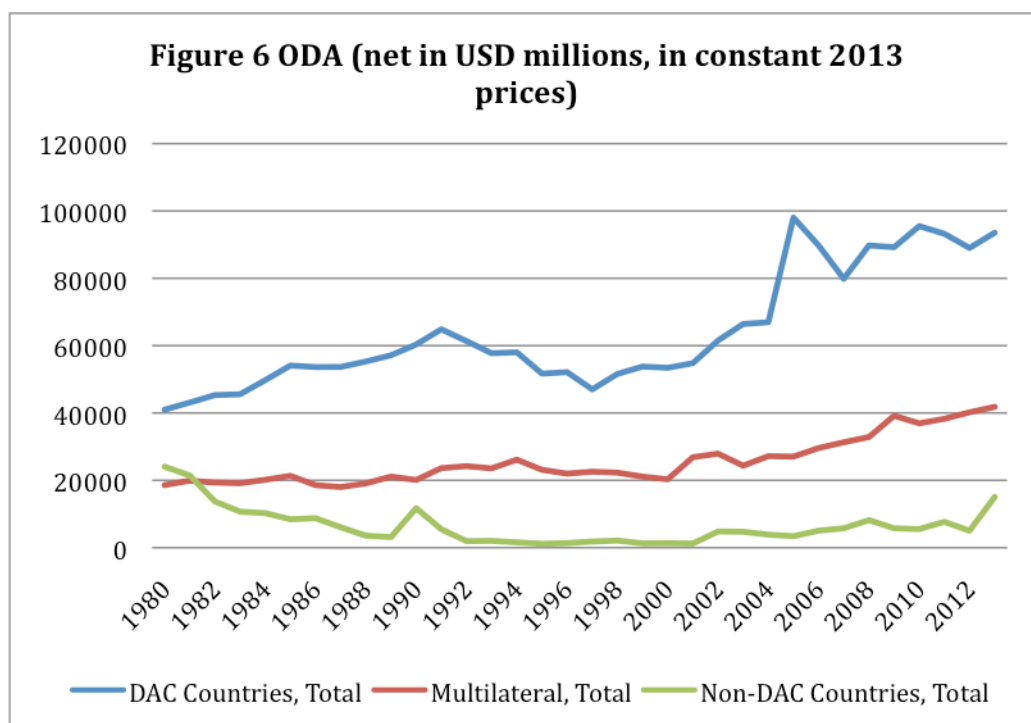
**Figure 5 Total Flows to UMICs**



Source: OECD STAT online database

ODA remains critical for Low Income Countries (LIC) in their attempts to accelerate economic growth and address poverty. It continues to play a crucial role in countries where there is limited interest from private investors (in particular for those items like infrastructure, traditionally financed by ODA) and for those countries that have limited access to international capital markets. ODA has suffered strong fallouts from the global financial economic crisis which has led to a tightening of aid budgets. Between 2010 and 2012 ODA fell by six percent in real terms (ODI 2015, p. 119).

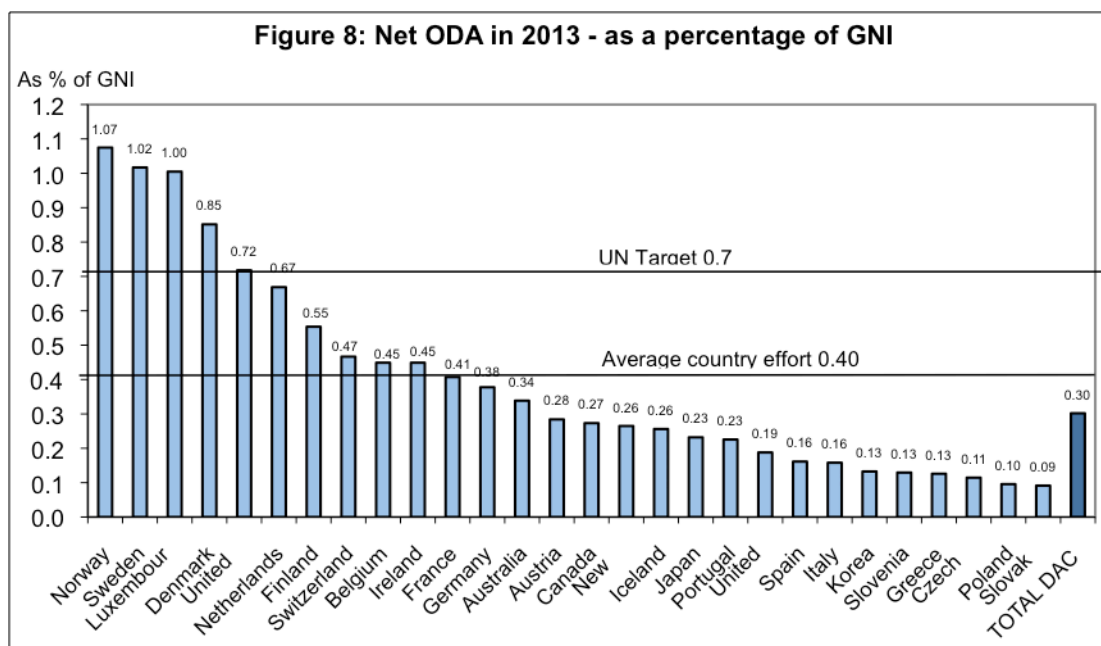
Figures 6 and 7 chart the changing patterns of aid since the 1980s for DAC, non-DAC and multilateral institutions to all developing countries (in constant and current USD). The trajectory of rising ODA from DAC donors (in real terms) since 2000 has been put in jeopardy since the global financial crisis so that the real value of ODA in 2013 for these donors was lower than in 2005. In contrast both multilateral and non-DAC donors have marginally and steadily increased their ODA flows since the 2000s.



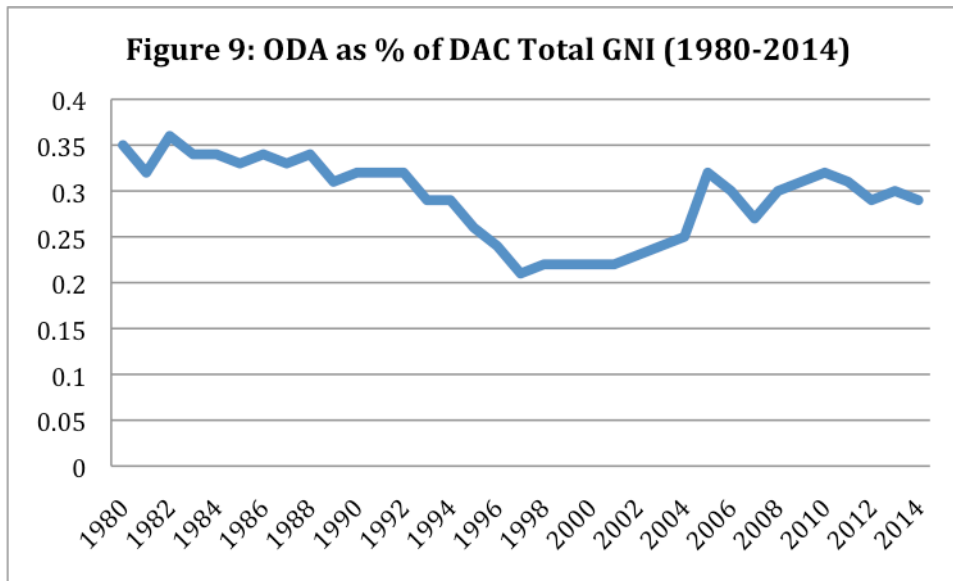
Source: OECD STAT online database

Serious concerns persist regarding the prospects for ODA levels as budgetary pressures in developed countries persist as a result of the crisis and substantial increases in ODA from many DAC donors seem unlikely in the future.

Aid flows to LICs fell for the first time in over a decade in 2012. Total net ODA flows were USD 150.6 billion (USD 134.2 billion in real terms) in 2012, 6 percent less (3.5 percent less in real terms) than a year earlier, reversing the rising aid trend since 1997. ODA is now equivalent to 0.4 percent of DAC donors' combined GNI (see figure 8), falling significantly short of the Monterrey commitment to increase the volume of aid to 0.7 percent of GNI by 2015. (World Bank 2013, p. 17). Only five countries (Denmark, Sweden, Luxemburg, Norway and the UK) met or exceeded the 0.7 percent target in 2013. Figure 9 traces the changing share of ODA as a percentage of DAC GNI. Once again the trajectory of ODA, considered in this way, has been disappointing. Despite donor rhetoric to the contrary (particularly during the mid-2000s), ODA as percentage of DAC GNI has remained stubbornly below 0.32 percent since 2000.



Source: OECD STAT online database



Source: OECD STAT online database

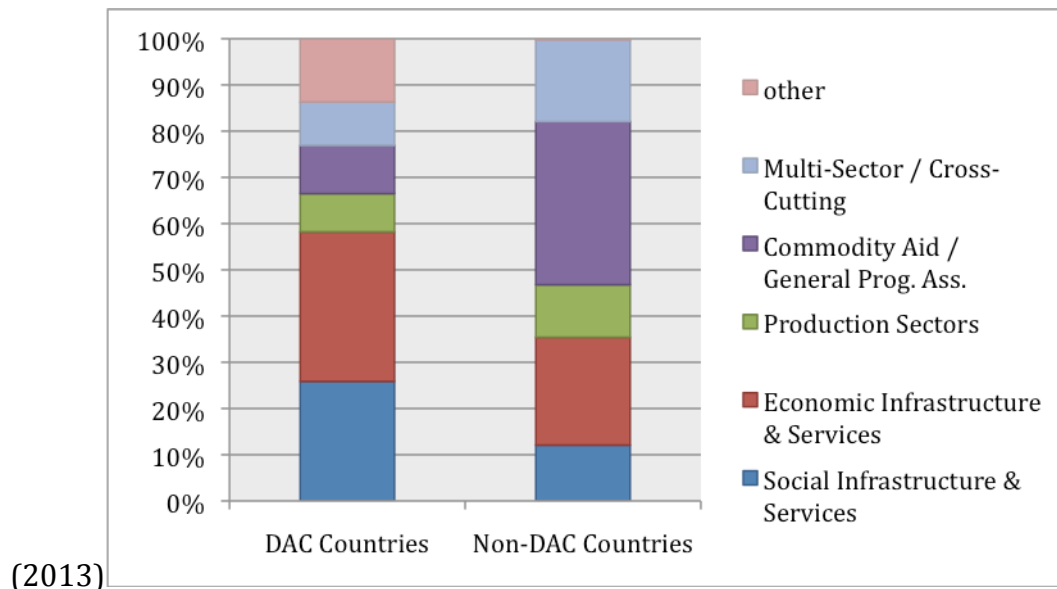
Alongside the above trends, there has also been a redefinition of the aid landscape.<sup>x</sup> Aid from OECD-DAC donors, including through their contribution to multilateral agencies, has become a less important source of development finance at the global level, despite growing rapidly prior to the global crisis. Non-traditional donors and South-South cooperation have, in contrast, grown in importance, particularly in the wake of the global financial crisis and particularly for certain sectors. Figures 6 and 7 highlight the growth of ODA from non-traditional donors that has been reported to the OECD.

By 2013 non-DAC donors accounted for 10 percent of total ODA flowing to developing countries (equivalent to USD 15bn) (see figure 7). Many of these countries, including China, Brazil, India and South Africa, do not systematically report on the levels and geographical distribution of their aid, nor are reporting standards and data methods uniform, making comparisons difficult (ODI 2015).

The non-traditional donors not only have different modalities for engaging with partners in the South, but have also favoured different sectors to support compared to traditional donors. Figure 10 demonstrates these sectoral differences between DAC and non-DAC donors. The importance of ODA classified as multi or cross-cutting sectors by non-traditional donors

partially reflects their new way of delivering support to developing countries that does not neatly fit into OECD-DAC classification systems.

**Figure 10: Total ODA by Sector**



Source: OECD STAT online database

Non-DAC donors are strong supporters of economic infrastructure as well as commodity aid or general programme assistance. Within support to infrastructure, further differences can be observed. Non-traditional financiers are mainly concentrated in power and transport sectors, whereas traditional donors are a dominant source of financing for water and sanitation. Thus, beyond increasing the volume of resources, new actors engaged in South-South cooperation are playing a complementary role, entering the areas left out of traditional financing with the greatest need (G24 Secretariat 2008; Griffith-Jones, Stephanie 2014). The G24 Secretariat (2008, p. 3) observes:

“In contrast to traditional donors who are more focused on budget support, human development and social infrastructure, the bulk of financing from non-traditional partners is in support of physical infrastructure development, often in oil and mineral exporting countries. The modalities of engagement are also markedly different with no recourse to conditionality but sometimes with other restrictions that are no longer used by traditional donors. These differences in motivations, conditions and modalities have

sparked a new debate about the role of new development partners in Africa. That debate has been constrained by a good understanding of the precise nature of the changing engagement.”

The new role of non-traditional donors is not restricted to their bilateral engagement with developing country partners. In fact, more recently, ideas have been launched around the prospect and viability of new multilateral institutions formed around South-South Cooperation. The BRICS development bank and the Asian Infrastructure Investment Bank (AIIB), have the potential to help meet the very large unmet needs in the emerging and developing countries in the field of infrastructure and more environmentally sustainable forms of development (Griffiths-Jones 2014; Humphrey 2015).

But beyond just the financial potential the development of large and effective BRICS institutions could provide a valuable platform for reforming the aid and development landscape and could significantly enhance the potential bargaining power of developing countries as a block (Griffiths-Jones 2014). For Humphrey (2015, p. 30):

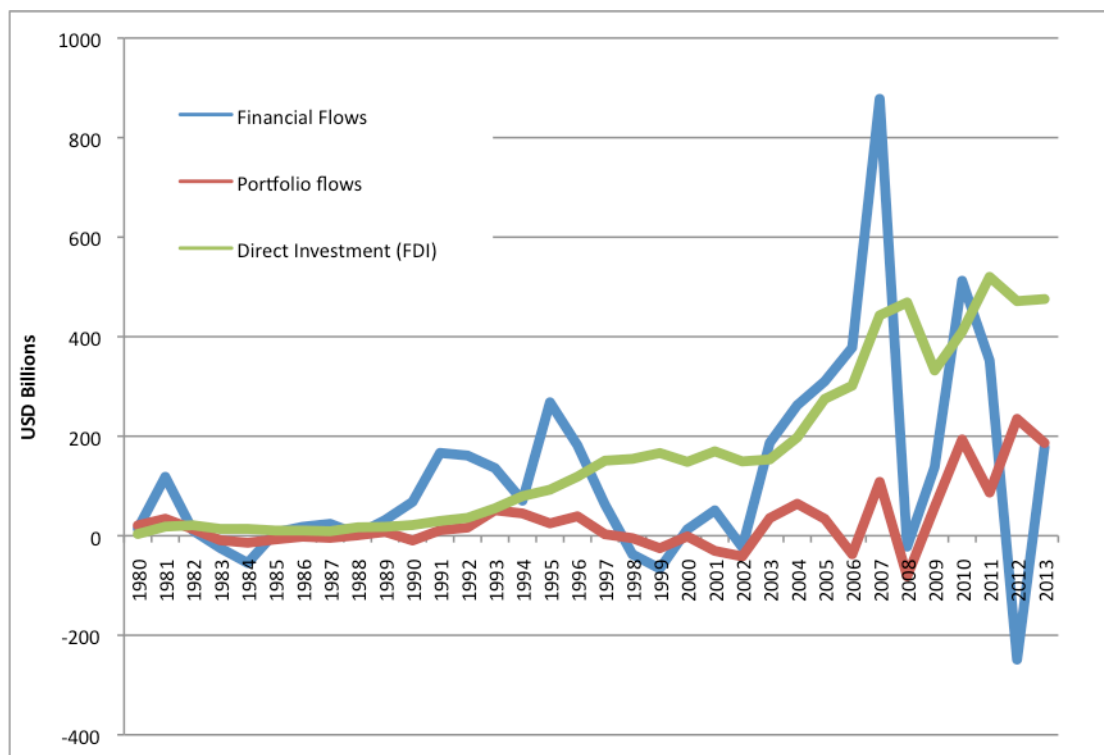
“The BRICS New Development Bank and the Asian Infrastructure Investment Bank together represent a bold step towards reordering the global system of development finance institutions. Emerging powers have no confidence that existing MDBs can be reformed to recognise their growing economic power, and are in any case insufficient to address the huge needs in developing countries. In broad terms, the creation of these new banks is a welcome move, and may mark the beginning of a new era in development finance and multilateralism.”

### 3.2 Private flows

There has been a fast acceleration of the integration of developing countries in the international financial system in the last decade. In this context, developing countries are often referred to as Emerging and Developing Economies (EDE), and we will use the terminology interchangeably. A central factor in this accelerated integration has been a surge in capital inflows to developing countries that started in the early 2000s (Akyüz 2014, p. 3). Tyson and

McKinley (2014) survey the trends in FDI, bank lending (financial flows), portfolio flows, and official flows, against the backdrop of the internationalisation of the financial system characterising the period from 1980 onwards. While, since the 1980s, there has been a long-term trend towards increased cross-border private capital flows, which came to be celebrated as crucial to development (see above), there are significant differences in growth rates and relative importance across different types of flows. Cross-border private capital flows typically consist of Foreign Direct Investment (FDI); portfolio flows – composed of equity and bond flows of various investors including pension funds, mutual funds, insurance companies, hedge funds and commercial banks; and financial (or debt) flows, which are mainly net bank lending (but also include bond issuances).<sup>xi</sup>

**Figure 11:** Net private capital flows to developing countries by type (1980-2013)



Source: Tyson and McKinley 2014, Figure 6

Between 1980 and 1990, private capital flows remained relatively limited, at an average of US\$ 36 billion annually. These flows were dominated during that decade by FDI and bank lending, accounting for 53 and 39 percent of total private cross-border flows respectively. Portfolio



flows only accounted for 8 percent of the total private cross-border flows during that decade (Tyson and McKinley 2014, p. 16). During the next decade, 1991-2002, private cross border annual flows accelerated rapidly, to reach an annual average of US\$ 220 billion, or 4.5 times the annual average of the 1980s. This acceleration was driven by FDI (accounting 56 percent of total private cross-border flows) and bank lending (41 percent of total), while portfolio flows remained relatively low. However, FDI was highly concentrated in developing Asia and Latin America, a trend that was to continue until 2013, as these two regions received 43 percent and 27 percent of global FDI respectively (between 1991 and 2013). Commercial bank lending was much more volatile than FDI, expanding initially rapidly if unevenly until 1997 (with a dip for the Mexico crisis) to collapse during the Asian and Latin American crises of 1997 and 1998 (and again 2002 with the Argentinean crisis) (p. 17).

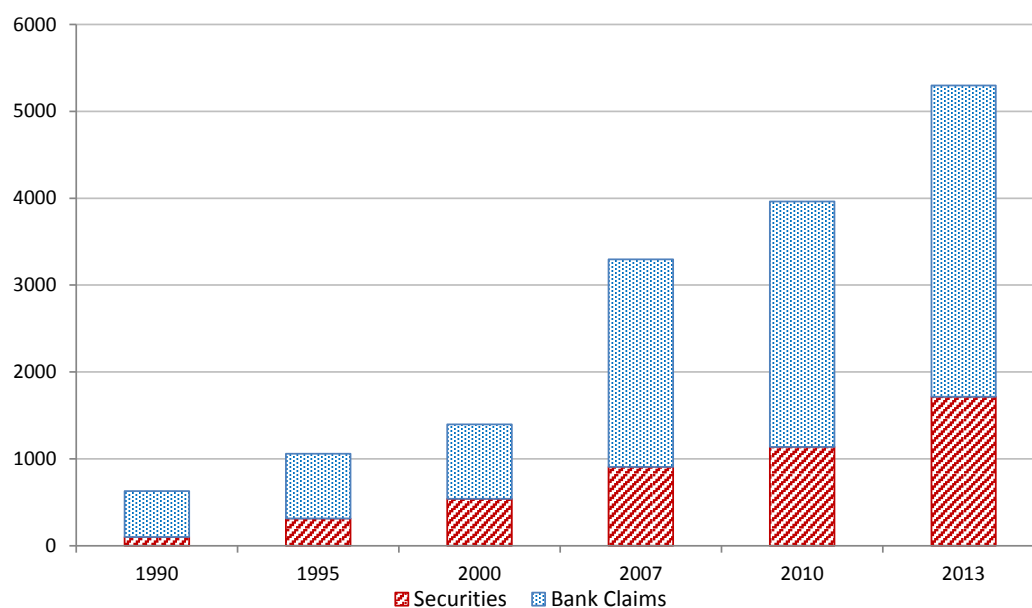
Tyson and McKinley (2014) discuss the noughties in terms of pre- and post-crisis periods. For the period 2003 to 2007, they point to the fast acceleration of private cross-border flow, now exceeding US\$ 700 billions annually,<sup>xii</sup> with commercial bank lending showing exponential growth between 2002 and 2007 – facilitated by the liberalisation of the capital account in various countries. The 2000s also see the arrival of outward FDI from Southern countries, with China leading.<sup>xiii</sup> By 2008, the financial crisis spread to developing countries, being transmitted to these countries through private cross-border flows (as well as through trade and commodity prices). Given that low-income countries had remained relatively on the margins of the fast expansion of cross-border private flows, they remained relatively shielded in terms of the impact on private capital flows. Middle-income countries that had liberalised their financial markets and opened up their capital accounts, however, were strongly impacted by the crisis, as total bank lending contracted sharply in response to the crisis, falling from a peak of \$853 billion in 2007 to a mere \$9 billion in 2008, and remaining volatile after 2008 (including a net outflow in 2012). Portfolio flows, which had grown during the pre-crisis period, also experienced a sharp contraction initially but resumed strong, if volatile, growth after 2008. Expansion of portfolio flows was particularly strong in 2010 and 2011, and while experiencing a sharp contraction in 2012, they increased again in 2013 (p. 20). For Tyson and McKinley (2014, p. 20) these trends reflected “push factors in advanced economies as investors, including those in the shadow banking system, sought yield opportunities outside of advanced economies, where quantitative easing had driven down interest rates and where periodic

speculation increased on the assumption of a reversal of such easing, especially in early 2013” (see also Tyson et al. 2014; Akyuz 2014).

In contrast, Tyson and McKinley (2014, p. 19) observe how FDI responded relatively little to the crisis, and indicate that, by 2012, post-crisis FDI inflows to developing countries exceeded inflows to developed countries for the first time. Finally, Tyson et al. (2014) also observe that the contagion of the crisis was not limited to volatility of flows, but also included sharp changes in financial costs, as emerging market debt spreads became more volatile. The authors add (p. 21) that: “[s]uch volatility can cause significant problems for developing countries, especially for government financing, as reliance on private capital flows implies that the cost and availability of financing cannot be ensured since they are subject to rapidly changing market sentiment” (see also Ostry et al. 2011).

As a result of these trends, external debt of developing countries has grown steadily since the 1970s, but its rate of growth has rapidly increased since 2002. A large proportion of external debt of EDEs is commercial debt (i.e. owed to the private sector), with official debt under 20 percent of total in recent years (Akyuz 2014, p. 24). International debt securities and bank loans constitute its two principal components.<sup>xiv</sup>

Figure 12: International securities and bank claims – all emerging and developing economies (billions of US dollars)



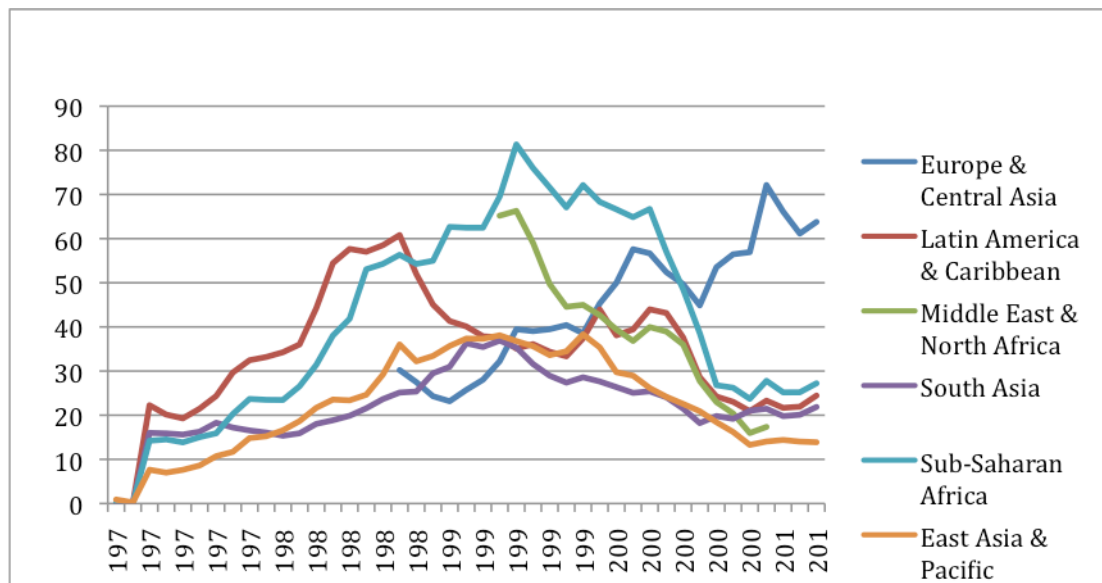
Source: Akyuz (2014), Chart 9a.

A significant feature of the growth in external debt is the increased proportion of external borrowing undertaken by the private sector. While during the 1970s and 1980s, external debt accumulation in developing countries was mainly through the public sector, from the early 1990s onwards, private sectors of these countries began to borrow abroad, with this trend accelerating rapidly since the mid-2000s (i.e. this proceeded gradually at first to gather a rapid pace from the mid-2000s onwards). While the private sector of developing countries had debts amounting to 5 percent of total external debts in 1989, by 2012, this had surpassed 35 percent of total external debts (Laskarides 2014, p. 5).<sup>xv</sup>

A crucial issue then is that the rapid rise in developing countries' external debt position over the last 15 years has been driven by the increases in international borrowing by the private sectors of developing countries (Laskarides 2014, p. 34; Akyuz 2015, p. 26). I.e. there have been large shifts in the relative shares of the public and private sectors in the external commercial debt of EDEs. For EDEs as a whole the private sector now accounts for the bulk of external debt both in international bank loans and securities.<sup>xvi</sup> We should add that as interest rates on private debts are higher than on public debt, this reconstitution of the relative evolution of public and private external debt has implications for debt servicing burdens. Since 2007, it has resulted in the majority of debt servicing of developing countries' external debt to be for debts of the private sector (Laskarides, p. 6).

At the same time, however, on aggregate, debt indicators of EDEs have improved over the last 3 decades (see Laskarides 2014, p. 7) as output grew rapidly across EDEs. External debt stocks as a proportion of GNI have converged for all regions except for Europe and Central Asia. But this masks considerable differences between regions regarding the distribution between public and private external debt. For SSA, for instance, the largest component of its debt has been official bilateral debt of the public sector and official multilateral debt, with more recently increased proportions of external debt being held by the public sector in the form of bonds, which is marginally surpassed by private sector external bank borrowing (Laskarides 2014, p. 13.)

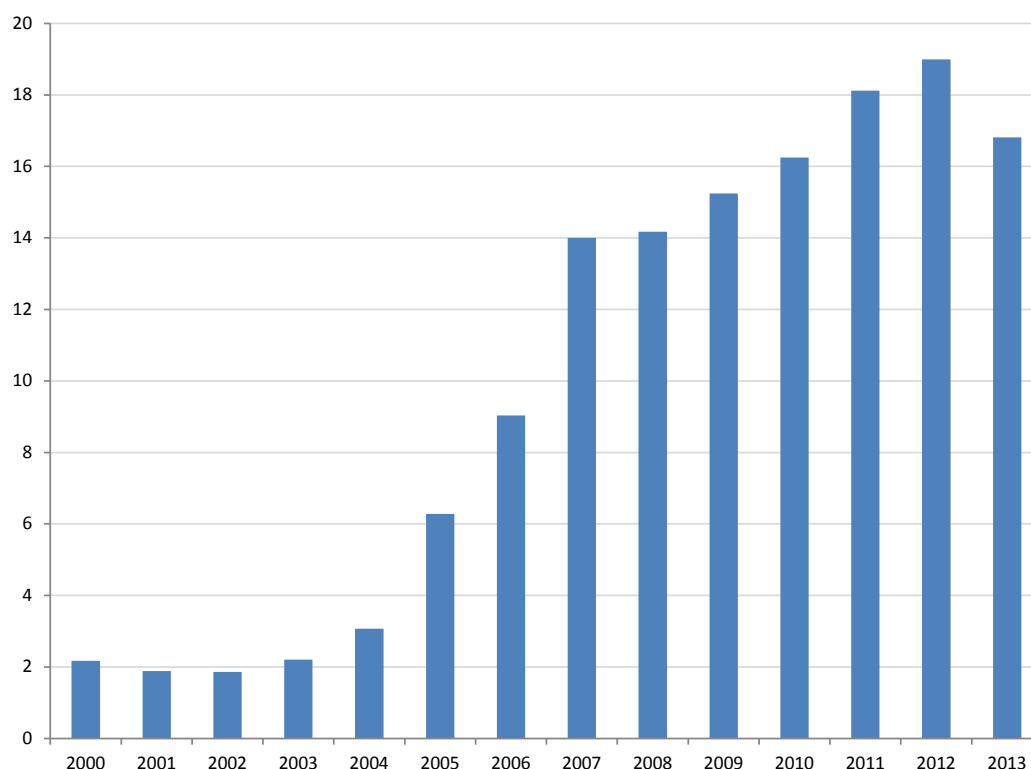
Figure 13: External debt stocks as share of GNI



Source: Laskarides (2014, p. 9)

It should also be noted that the currency composition of total external debt of EDEs has shifted towards local currencies. Akyuz (2014, p. 27) points towards three reasons for this trend. First, there has been a sharp increase in the share of local-currency bonds and notes in international issues by both governments and corporations. Second, domestic securities issued in foreign currencies or linked to the exchange-rate have become less important. Third, many governments in EDEs have shifted from international debt in foreign currency to domestic debt in local currency and opened domestic debt markets to foreigners (Akyuz 2014, p. 29). These countries have benefited from the increased willingness of international lenders to assume the currency risk and to be under local jurisdiction in return for higher yields and large capital gains (p. 29). “This together with growing private sector issues in local markets, has led to a rapid expansion of domestic debt securities relative to international debt securities” (Akyuz 2014, p. 29).

**Figure 14:** Share of domestic currency bonds and notes in total international issues by Emerging and Developing Economies (per cent)



Source: Akyuz (2014), Chart 10.

However, Akyuz (2014, p. 33) adds that since a large proportion of external debt of EDEs remains in bank loans and as these, as well as the official debt, are mainly in foreign currencies, the bulk of total gross external debt for many countries is in foreign currencies despite recent increases in the share of local-currency debt. The author adds:

“This is true particularly for poorer countries dependent on official lending, countries with rudimentary domestic debt markets or with too low a credit rating to be able to attract foreign investors to domestic debt markets or to issue local-currency dominated international bonds”.

Indeed, a lot of the discussion above regarding private cross-border flows during the noughties relates to MICs (with a few countries, including China, Brasil and India often dominating the picture). LICs receive a small yet growing share of private cross-border flows to developing countries. This amounted to 1.8 percent of all private cross-border flows between 2003-2007, but grew to 3.2 percent of all flows in the period 2010-2013 (with these flows accounting, by 2012 for 6.5 percent of low income countries GDP, above the average of 6 percent for all developing countries) (Tyson et al. 2014, p. 7). Net FDI flows to LICs have grown steadily since

2003, standing at six times their 2002 (absolute) level in 2012, accounting for 3.9 percent of total FDI flows to developing countries and 5.2 percent of GDP. These trends include “increasing participation in FDI sources from other developing countries, notably China, India and the UAE”. FDI to LICs has also somewhat diversified away from its previous focus on extractive industries, to include now also financial services and tourism. This growth in FDI remains however concentrated in a few LICs (including Bangladesh, Cambodia, Mozambique and Tanzania). Further, 2013 saw a surge in portfolio flows to LICs, which had previously been negligible, as a result of LIC sovereign bond issuances, including by Tanzania, Kenya, Rwanda, Mozambique and Uganda (see also te Velde 2014). A growing number of LICs, notably in SSA, have been issuing Eurobonds and many of them for the first time, as these countries take advantage of expansion in global liquidity, lower interest rates and improvements in global risk appetite (see also Tyson et al. 2014, p. 9). These first-time issues between 2009 and 2013 reached almost \$9 billion. While average size was small, at some \$450 million, it reached 10 percent of GDP in some of them (Guscina et al. 2014). Such issues however imply significant currency and refinancing risks (see also Tyson et al. 2014, p. 9; te Velde 2014).

In sum, there has been widespread liberalisation of the rules governing direct and portfolio equity investment allowing for an “escalation of foreign presence and influence in the real and financial sectors of EDEs”. Domestic markets have been opened to foreign banks. And as a result of capital account liberalisation, both financial and non-financial corporations have had greater access to international financial markets “flooded with cheap money” in the wake of the GFC (Akyuz 2014, p. 5). These developments of accelerated integration within international capital flows have been mirrored in fast international reserve accumulation in developing countries (see Laskarides 2014; Tyson and McKinley 2014). Akyuz (2014, p. 13) observes that the share of international reserves in total external assets of EDEs increased “from less than a quarter in 2000 to 43 percent by 2013”. He adds that of some \$7 trillion reserves accumulated after 2000, “almost two-thirds are earned from current account surpluses and one-third are borrowed – i.e. put aside from capital inflows”. This implies that over 40 percent of total reserves of EDEs in 2013 were borrowed reserves, which accounts to close one-half of EDEs’ total gross external debt in that year (ibid.). Akyuz (2014, p. 15) comments that this unprecedented reserve accumulation by developing countries:

“goes directly against the prognostications of mainstream theory that the need for international reserves should lessen as countries gained access to international financial markets and became more willing to respond to balance-of-payment shocks by exchange rate adjustments. However, capital account liberalisation and increased access to international financial markets have produced exactly the opposite result. Private capital flows have no doubt allowed larger and more persistent current account deficits in EDEs beyond the levels that could be attained by relying on borrowing from the BWI or bilateral lenders. But this has also meant accumulation of large stocks of external liabilities. Because of procyclical behaviour of international financial markets, EDEs have become highly vulnerable to sudden stops and reversals in capital flows and this increased the need to keep reserves as self-insurance”.

Hence, while developing countries have been recipients of large private financial flows, these have been mostly “recycled back” to advanced countries in the form of foreign exchange reserve accumulation (Laskarides 2014, p. 59).<sup>xvii</sup> For LICs, international reserves reached 9 percent of their GNP in 2012 (Tyson et al. 2014b, p. 4). Foreign reserves have been increasingly accumulated by developing countries to protect themselves against the risks associated with increased international financial integration (volatility of financial flows; reduced autonomy in monetary and fiscal policy when a payment crisis occurs; etc. ). These reserves however carry high opportunity costs for capital scarce countries (see Akyuz 2014; Tyson et al. 2014).

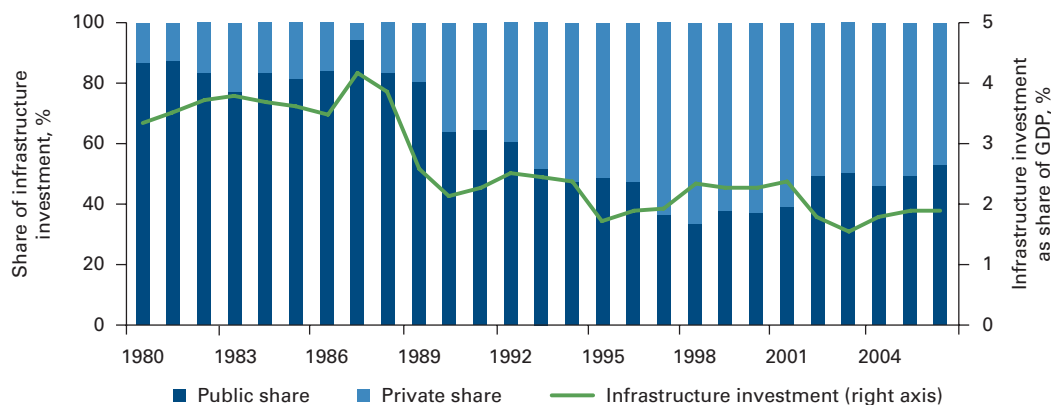
#### **4 Domestic Resource Mobilisation**

The 2015 Trade and Development Report (United Nations Conference on Trade and Development 2015) highlights the hazards of accelerated financial integration of developing economies. These relate both to the scale and the volatility of short-term flows with implications for the financing position of countries, their exchange rate, and their fiscal position when private debts become “nationalised”. Some of these risks have started to materialise ahead of the much-anticipated scaling back of quantitative easing in the USA (see also Akyuz 2014). Financial integration hence carries a host of risks raising the imperative of domestic resource mobilisation (DRM) and improvements thereof. For most countries, DRM is the largest resource available to fund national development plans. A country’s ability to mobilize domestic resources and spend them effectively—at the national, sub-national and



municipal levels—lies at the crux of financing for development. Figure 15 below is drawn from a World Bank Global Development Horizons Report (Dailami, et al. 2013, p. 29) and highlights the crucial role of government spending in funding development. It illustrates how, on average for Latin American countries, as the share of public investment in total infrastructure investment falls, infrastructure investment as a share of GDP also falls. Public investment is crucial to expanding domestic capital formation.

**Figure 15:** Shares of infrastructure investment in GDP for Latin American countries and relative shares of public and private infrastructure investment



Source: Dailami et al. (2013, p. 29)

There have been strong improvements in domestic resource mobilisation efforts in the developing world over the last 15 years. A report for the European Parliament, highlights how over half of all developing countries have experienced real average growth in total government spending of 5 percent per year or more between 2000 and 2011 (Griffiths et al. 2014, p. 10). For almost 30 countries this was in excess of 8 percent (per year). For developing countries as a whole, the ODI (2015, p. 97) reports that “domestic public revenues (tax and non-tax) increased by 272%, from \$1,484 bn in 2002 to \$5,523 bn in 2011”. While there important various across countries, tax to GDP ratios are above 15 percent in around half of all developing countries. There further remain important potential tax increases to be realised across all country income groups with significant implications for domestic resource mobilisation (see Table 1 below which is drawn from (Atisophon et al. 2011).

**Table 1: Potential Tax Increases by Income Group**

Income Group	Average Potential Tax Increase as a Share of GDP	Total Potential Tax Increase
Low-income	2.5%	USD 3 billion
Lower middle-income	4.7%	USD 1 billion
Upper middle-income	3.1%	USD 60 billion

**Source:** Atisophon et al. (2011, p. 41), Table 9

The origins of government revenues differ between countries, with resource-rich developing countries relying heavily on extractive industries. Griffiths et al. (2014, p. 10) indicate that 40 percent of tax revenue in African countries (for the period 2008-2011) was derived from natural resources. This exposes government revenues to vulnerability to volatile commodity prices. Akyuz (2014, p. 38) highlights how in Latin America, an important part of the decline in budget deficits after 2002 was due to rising commodity prices, with revenues from commodity taxes, profits and royalties accounting for as much as 50 percent of the total increase in the fiscal revenue ratio in some countries. Further, many developing countries face narrow tax bases and lose significant resources as a result of illicit financial flows or as a result of tax exemptions (including those obtained through investment treaties). The European Development Report estimates that illicit financial flows amount to around \$542 billion per year on average during the 2002-2011 period. Around 80 percent of these flows “are due to trade mis-invoicing, a practice which undermines government efforts to tax companies” (ODI 2015, p. 103). Moreover, it is not only the level of taxation that matters, but also its structure, which has powerful effects on fairness. In this regard, the key trend is one of a continued increase in revenue collection through value-added tax (VAT), a continued decline in tariff revenues, and a continued weakness in personal income tax (World Bank and IMF 2015, paragraph 17). And while the progressivity of the tax system needs to be assessed in conjunction with the distributional impact of the spending it finances, it remains a concern “that the tax instrument that most directly addresses equity concerns remains underdeveloped”.

Domestic resources can also be mobilized through domestic borrowing and there has been an increased trend in mobilizing through local bond markets,<sup>xviii</sup> including at sub-sovereign levels.

For Platz (2009) the latest global financial and economic crisis has created a renewed interest in mechanisms that allow limiting a country's exposure to international flows and currency movements, prompting interest again in the possibilities of domestic capital markets for funding investments through debt issuances in local currency. The author explores the scope for such public bond issuance at the sub-sovereign level in the context of raising capital for infrastructure investments. This would assist in empowering local government authorities or municipalities to improve public service provision and resist privatisation pressures. The author seeks to assess the extent to which the US experience with sub-sovereign bonds can provide guidance for public infrastructure investments elsewhere. He argues that:

“while international experience with these instruments is generally limited, municipal bonds have been an extraordinarily successful vehicle for cities, towns and counties in the US to raise capital for infrastructure investments” (p. 2).

Moreover, he points to research that shows that the emergence of the municipal bond market in the US contributed to a shift in ownership structure of waterworks from private to public providers. While in certain developing countries, lower levels of government (or municipalities) have engaged in the issuance of municipal bonds (e.g. in Mexico, India, South Africa, Columbia, Brasil<sup>xix</sup>), Platz (2009) reminds us that such a way of mobilizing savings for public or infrastructure investment necessitates a certain level of domestic financial market development (see p. 19 onwards).

Ultimately, the ability of a government to implement growth-inducing macroeconomic policies depends on its fiscal space, i.e. its ability to raise revenue and rely on debt instruments or external grants for financing (see UNCTAD 2009 and above). It has been repeatedly emphasised in the literature that running deficits can be justified, in general, on two major counts. First, government expenditures can be used to compensate for falls in private spending during economic downturns. Second, running deficits is fully justified, even in non-recessionary periods, to support public investment Weeks and McKinley (2007). This is the development rationale for running a deficit. Indeed, Weeks and McKinley (2007) insist that it makes little sense to use current revenues to finance public investment since the additional future revenues expected from the investment should pay off the debt that the government

initially incurred. It is through this development function that public investment can stimulate private investment and boost economy-wide labour productivity (see United Nations Conference on Trade and Development (2009).<sup>xx</sup> Finally, Chowdhury and Islam (2010) reminds us that the frequent “preoccupation with identifying prudential limits on public debt-to-GDP ratios have had the consequence of distracting attention from the crucial role that fiscal policy plays in promoting growth and development”. The authors insist that the relationship between the debt-to-GDP ratio and macroeconomic instability is weak and provide a convincing argument to move beyond the imposition of financial straightjackets implied by conformity to alleged “optimal” debt-GDP ratios in favour of publicly-financed (or deficit-financed) investment to stimulate growth.

In this context, it should be noted that the general fiscal position of the developing world has improved substantially over the last 10 years, with fiscal deficits, after worsening as a result of the GFC, well within the conservative bounds (of -3 percent of GDP).

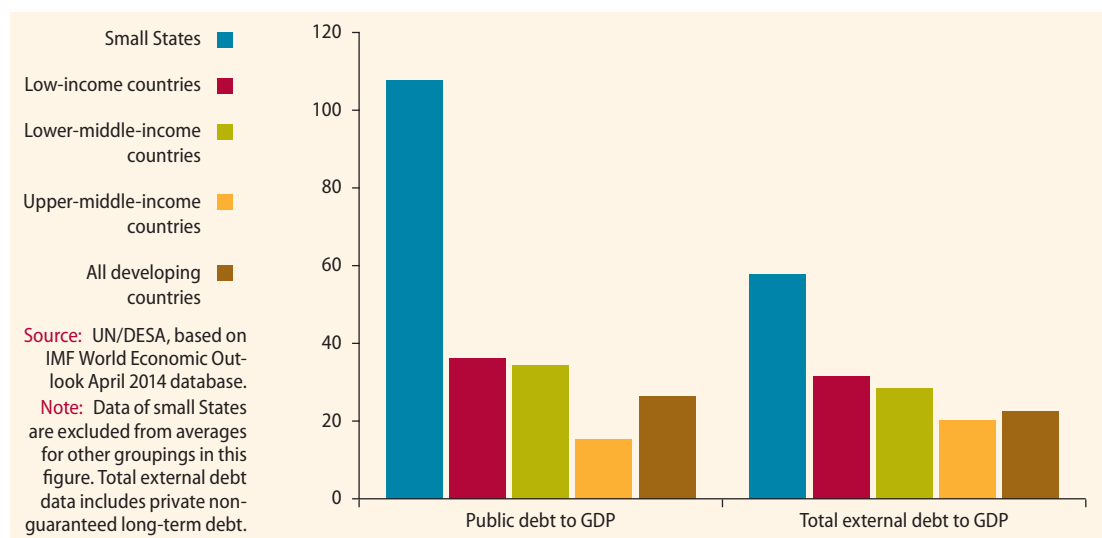
**Figure 16:** Fiscal balances of low and middle-income countries, 2005-2013 (share of GDP)



Source: United Nations (2014, p. 46).

In addition, the public debt situation in various countries has improved markedly, with public debt/GDP ratios at historically low levels.<sup>xxi</sup>

**Figure 17:** Debt-to-GDP ratios of small states and other developing countries (percentage), 2013



Source: United Nations (2014, p. 42).

Apart from mobilisation through the tax system or through domestic borrowing, the state plays a role in domestic resource mobilisation with its capacity to mobilise domestic savings through such mechanisms as mandatory retirement programmes, pricing policies of state-owned enterprises or through strategic interventions in domestic financial institutions. In the context of the latter,

public financial institutions can take on a specific role. The UNCTAD 2009 Least Developed Countries Report highlights that: “Despite reported inefficiencies, they were often effective at performing the essential function of mobilising and allocating long-term investment-focused development finance” (p. 82). Public financial institutions can take different forms, including development banks, agricultural banks, as well as postal savings banks. Marois (2013) documents the importance of state-owned banking assets across faster growing emerging economies (including Brasil, Russia, India, China and Turkey). Marois (2013) presents a set of arguments in favour of state-owned banks (including those that take public deposits) and dispels common mainstream myths that have undermined the case for them since the rise of neoliberalism. Marois (2013) reminds us that by the 1970s “the state-owned banks controlled

40 per cent of combined banking assets in developed countries, and 65 percent of assets in developing economies” (p. 2). Today, that asset base has shrunk considerably, but some significant state-owned banks still exist with state authorities controlling “an estimated 22 per cent of banking assets in emerging economies and 8 percent in advanced economies”. Table 1 below, reproduced from Marois (2013, p. 7) gives an overview of the significance of state-owned banks in a set of countries. He also draws attention to the fact that many of the fastest growing emerging economies over the last decade have among the highest levels of state bank ownership (see e.g. Brasil, Russia, India, China and Turkey) (p. 16).

**Table 2:** State-owned banking assets, selected countries, share of total (2008-2010).

	ARGENTINA	BANGLADESH	BRAZIL	BURUNDI	ECUADOR
2008	37.7%	37.8%	39.8%	49.1%	11.77%
2009	39.1%	35.2%	44.1%	48.1%	16.18%
2010	43.6%	34.1%	43.5%	48.9%	16.53%
	EGYPT	GERMANY	INDIA	INDONESIA	REP. OF KOREA
2008	49.30%	35.44%	69.85%	38.20%	22.20%
2009	48.50%	36.08%	71.88%	39.70%	22.40%
2010	---	31.52%	73.70%	38.41%	22.30%
	KYRGYZSTAN	LATVIA	POLAND	PORTUGAL	RUSSIAN FED.
2008	17.50%	10.50%	17.00%	21.04%	38.00%
2009	81.00%	17.10%	21.00%	21.73%	40.60%
2010	20.30%	15.50%	22.00%	22.64%	40.80%
	SIERRA LEONE	SRI LANKA	THAILAND	TURKEY	VENEZUELA
2008	41.49%	55.50%	22.20%	30.50%	11.90%
2009	38.62%	57.80%	21.70%	32.20%	22.01%
2010	37.71%	59.10%	17.50%	31.60%	33.06%

Source: Marois (2013, p. 7).

Marois explores the possibilities that state-owned banks offer in financing public infrastructure and other strategic sectors or activities in an economy. His account draws on the experience with state-owned banks in Brazil, China, Costa Rica, India, South Africa, Turkey and Venezuela. He highlights how, as state-owned banks are not necessarily exclusively driven by profit imperatives, i.e. they have a different reproductive basis than private banks, they can exist without having to turn a surplus, differentiating them from private banks in how they can allocate resources. This may imply that state owned banks “can provide longer term credit to fund infrastructure and social investment than private banks” as they do not face the immediate short-term profit imperative (p. 16).

The scope for domestic resource mobilisation through such mechanisms as national development banks or public pension funds is further explored in detail through close examination of a set of case studies in Working Paper 157.

## 5 Conclusion

It was illustrated above that a fluid mix of international resources flows to and from developing countries. The mix, however, varies considerably across countries and has various hazards attached to it (see Tyson et al. 2014; Akyuz 2014; Laskarides 2014). It was also demonstrated that there are various channels through which developing countries can seek to mobilise resources domestically which, depending on the channel through which these are mobilised, may lower exposure to the hazards of increased international financial integration.

Financing development necessitates rapid increases in investment levels, which are themselves supported by public investment. The nature of the integration of a specific country in the international circuits of finance, trade and production will strongly affect their capacity to raise their investment rates. The Working Papers 140 and 157 explore two separate issues bearing on the scope for financing development. Working Paper 140 considers closely a particular shift in development cooperation that has been taking place since the early 2000s with potentially strong implications for the level and nature of investment financing for development. Working Paper 157 focuses on different scenarios of domestic resource

mobilisation, some more successful than other, and does this through a close look at four different cases.

<sup>i</sup> See Cameron (1972) and Goldsmith (1969) for a critique and for an attempt to deepen the research agenda on finance and development to include such issues as the size of the financial system relative to the economy, the distribution and density of banks, the demand for financial services, and the attitudes of authorities and elites toward finance, in an attempt to assess how “structural characteristics of a particular economy, as well as its laws, regulations and customs, make different financial systems appropriate at various stages of development” (Powell and Van Waeyenberge 2010).

<sup>ii</sup> Te Velde and Griffith-Jones (2013, p. 9 my emphasis), for instance, brings together a set of contributions in the context of a research project that has “initiated or re-emphasised a number of important debates on what features of financial sector development are conducive to LICs to structurally transform their economies”. These include issues bearing on financial markets and structural transformation such as questions around the “appropriate depth, size and growth of the financial market for structural transformation”; issues around cost of finance versus efficiency of financial sector; issues around the mechanisms to increase availability of long-term finance (including whether there is a need for development banks?); issues bearing on regulation and financial inclusion (including of small and middle sized enterprises – “the missing middle”); issues related to desirability of different types of capital flows (what is the role of different types of international capital flows in financing structural transformation and growth and how can these be regulate not to undermine macroeconomic stability) (p. 9).

<sup>iii</sup> Aizenman et al. (2007) find that the average self-financing ratio (share of domestic capital financed by national saving, without reliance on external borrowing) for developing countries is about 90 percent and that this ratio has remained stable throughout the 1990s despite the wave of financial liberalisation. See also Cameron (1972) on the “allocation puzzle”; Prasad, Rajan, and Subramanian (2007) on the positive correlation between current accounts and growth; Jeanne, Subramanian, and Williamson (2012) on the absence of a link between free capital movement and growth; and Rodrik and Subramanian (2009) on the effects of capital account liberalisation on the real exchange rate.

<sup>iv</sup> See Bonizzi (2014) for a comprehensive and critical survey of the literature on financial sector development (including international financial integration) and growth.

<sup>v</sup> See Van Waeyenberge (2006) on the transition from Washington to post-Washington Consensus.

<sup>vi</sup> “Financial repression” has been used to denote a whole series of measures including capital controls, restrictions on entry to the financial sector, government ownership of banks, the use of directed credit (say to agriculture or SMEs), interest rate ceilings, etc.

<sup>vii</sup> Following Levine (2004) these include: producing information; allocating capital to productive uses; monitoring investments and exerting corporate control; facilitating trading, diversification and management of risk; mobilising savings; and easing the exchange of goods and services. See also Beck (2013) in Te Velde et al. (2013) for a summary of the various positive effects that the literature has highlighted in the relationship between finance and growth.

<sup>viii</sup> See also Aizenman, Jinjarak, and Park (2015) on non-linearities in the finance-growth relationship and heterogeneous effects across sectors.

<sup>ix</sup> The term external “development finance” is most commonly used to designate long-term financial flows to middle and LICs, with the destination of the flows rather than their projected purpose serving to categorise them. Within the composite term of development finance, distinctions are traditionally made between flows that originate in the public or private sector (official versus private flows), between those whose projected purpose is related to development (development versus other flows), and over the financial terms on which the flows are provided (concessional versus non-concessional flows). Several categories therefore emerge. These have been typically defined by the Development Assistance Committee (DAC), the principal body through which the OECD countries (which historically account for the bulk of flows to developing countries) seek to align their funding and technical assistance (TA) activities.

<sup>x</sup> The Overseas Development Institute (ODI) has developed a new taxonomy of development assistance flows, see Greenhill, Prizzon, and Rogerson (2013).

<sup>xi</sup> Note that Akyuz (2014, p. 17) draws attention to the potentially arbitrary nature of the division between FDI and portfolio equity. For a flow be classified as FDI implies the acquisition of at least 10 percent of voting stock in



a new or existing firm, with ownership below 10 percent treated as portfolio equity. "Ownership of 10 per cent or more is seen to imply the existence of a long-term, stable relationship between the investor and the enterprise and a significant degree of influence on management (IMF 2009)". However, Akyuz (2014, p. 17) contends, "there is no compelling reason why investment in 10 percent ownership or more should be less fickle than in 9.9 percent".

<sup>xii</sup> This breaks down as follows: average annual FDI at US\$ 274.1, average annual net banking lending at US\$ 403.1, annual average portfolio flows at US\$ 40.9.

<sup>xiii</sup> Asia accounted for 31 percent of global outward FDI in 2012, with this being primarily driven by China.

<sup>xiv</sup> Akyuz (2014, p. 24) observes that this contrasts to the first boom in capital flows to EDEs in the late 1970s and 1980s, when much of the external debt was accumulated in syndicated bank loans

<sup>xv</sup> Laskarides (2014, p. 5) adds that this trend is partially due to the size of debt-financed FDI by corporations within emerging markets, and debt-financed merger and acquisition activities. "A significant source of private sector indebtedness in emerging markets seems to arise from the aspirant transformation of emerging market companies into multinational companies".

<sup>xvi</sup> Laskarides (2014) provides a detailed breakdown of how the profile of external indebtedness differs across different income categories of countries. The rise of the private sector external commercial indebtedness is particularly the case for upper middle income countries, and has occurred to a lesser extent in lower MICs where private sector external debt grew very fast from 2002 onwards, but where this was mimicked by fast public external debt growth from 2005 onwards. For LICs private non-guaranteed debt remains close to zero. Maturity structure of external debt also varies according to income category, with LICs having lowest proportion of external debt with short term maturities (standing at around 10 percent since 1972), while for lower MICs, this remained around 15 percent until 2005, after which there was a rapid rise of short term debt. For upper MIC, an increasing proportion of external debt has been of a short term nature, rising rapidly since 2001, to reach over 30 percent in 2012. For LIC, 50 percent of their debt is multilateral and around 70 percent on concessional terms.

<sup>xvii</sup> See also Aizenman and Lee (2005) and Choi et al. (2007) for evidence on the strong correlation between capital account liberalisation and reserve holding and the tendency to absorb capital inflows into reserves rather than use them for current payments (Akyuz 2014).

<sup>xviii</sup> In which there has also been increased foreign participation as already discussed above. On the danger of global financial spillovers to emerging market sovereign bond markets, see Ebeke and Kyobe (2015).

<sup>xix</sup> See Platz (2009, p. 7) on while Rio de Janeiro was the first city in Latin America to issue a bond in the international capital markets, tight fiscal regulations subsequently effectively prevented municipal bond issuances in Brasil.

<sup>xx</sup> Research from Brazil indicates that public investment is self-financing although it takes ten years for government to collect sufficient tax revenues and there are methodological issues with such an assessment (Calderon and Serven 2010).

<sup>xxi</sup> Akyuz (2014, p. 64), however, draws attention to the contingent liabilities that are created for the state through the rapid accumulation of private debt in developing countries, as the state is often drawn up for bailouts through recapitalisation of banks in case of the latter's failures. Akyuz (2014) uses the cases of Spain and Ireland during the Eurozone crisis as an illustration. On the eve of the crisis, their public debt respectively was 36 and 25 percent of GDP. The countries were running current account deficits (6 and 2 percent respectively), but these were due to a private savings gap and a growing part of the external debt has been incurred by the private sector. With the crisis in the banking system, a large part of unpayable debt was socialised through bailout operations. The result has been an increase in sovereign debt ratios to reach 100 and 120 percent respectively by the first half of 2014.

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## THE ABSTRACT OF THE PROJECT IS:

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

## THE PARTNERS IN THE CONSORTIUM ARE:

Participant Number	Participant organisation name	Country
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3	School of Oriental and African Studies	UK
4	Fondation Nationale des Sciences Politiques	France
5	Pour la Solidarite, Brussels	Belgium
6	Poznan University of Economics	Poland
7	Tallin University of Technology	Estonia
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