Is global finance finally shrinking?

By Jayati Ghosh
March 23, 2013 – *Frontline*, Vol. 30, No. 6

It is obvious that the recent boom in global capitalism had witnessed massive over-extension of finance. What has been described as "financialisation" reflected not only the ever-greater penetration of finance capital into more activities of the real economy and involvement in critical markets such as those for commodity futures that affect traded prices of food and fuel, but also huge and volatile movements of capital across national borders. By 2007, global stocks of financial assets (both equity and debt stocks) amounted to $206 trillion. This meant that financial assets were more than 4 times the maximal estimate of GDP in developed countries in that year, and nearly twice the value of GDP in developing countries.

But did this actually change from 2008? Is it the case that the global financial crisis and its ramifications have actually had some effect in causing this financial froth to subside? A new report from the McKinsey Global Institute based on its database of financial assets in 183 countries across the world suggests that this might be the case.

("Financial Globalisation: Retreat or Reset?", March 2013, McKinsey Global Institute, http://www.mckinsey.com/insights/global_capital_markets/financial_globalization)

According to this report, the estimated value of global financial assets grew rapidly (by more than 8 per cent per annum) in the decade up to 2007, but since then they have grown by less than 2 per cent per annum. Cross-border capital flows fell sharply in 2008 to $2.2 trillion, down from $11.8 trillion in 2007 (at constant 2011 exchange rates). In 2012, they were estimated at $4.6 trillion, around 40 per cent lower than the 2007 peak. Equity assets and securitised loans have actually declined in value.

Much of this was due to the reduction of capital flows within the developed world. The European economic crisis has played an important role in this, such that nearly half of the decline in cross-border capital flows is because of Western Europe alone. For example, since the last quarter of 2007, Eurozone banks have reduced foreign claims by $3.7 trillion. $2.8 trillion of this was on other banks within Europe, and $1.2 trillion was only on banks from the crisis-ridden GIPSI countries (Greece, Ireland, Portugal, Spain, Italy). But even in developing countries the process of financial expansion is slowing down, though it still continues, especially with the continuing growth in bond markets.

This is essentially good news. Most of the increase in finance in the "roaring 2000s" up to 2007 was not just unsustainable - it was also unnecessary and even undesirable. It did generate booms in some advanced countries (particularly the US and some European countries), which in turn fuelled export-driven expansion in some developing countries including China. But this was only because finance supplied a means of compensating for the potential stagnation and lack of demand that emanated from growing inequalities in income distribution. By generating demand based on borrowing rather than on actual incomes, finance also accentuated asset inequalities, putting more money in the hands of financial intermediaries while drawing people, companies and even governments into eventually unrepayable debts.

The pyramiding of finance meant that an essentially top-heavy and extremely entangled system was created, not just within countries but globally. Most of the so-called "financial deepening" of that period was due to financial system leverage (as banks and other players essentially borrowed from one another) increasing stock market valuations. "Plain vanilla" credit stopped being the purpose of the financial system, and instead became the base for an ever more complex system of securitisation and other extensions.

Financial "innovation" in the form of new instruments and products as well as forays into markets like those of commodity futures created the illusion of dynamism that was not based on any real contributions to the economy. Instead, the boom was associated with all sorts of speculative capital movements that were oriented to risky high-return assets, created very uneven and imbalance expansion. The inadequate monitoring in turn was associated not just with irresponsible behaviour but downright malpractice, all masked by the prevailing financial euphoria.

As we have found repeatedly to our cost but still do not seem to learn, such bubbles must burst. 2008 marked one such puncturing, but not a complete one. Indeed, the relatively slow reduction in financial valuations and the renewed profitability of banks and other financial institutions (with the continuing award of bonuses for senior managers) suggests that if anything, the process has still not gone far enough. Clearly, more reductions in finance are required and will eventually occur.

The concerns about global finance may be even greater for developing countries. While it is true that these countries still show significantly lower ratios of "financial deepening" it is evident that this is not necessarily a bad thing. But these countries continue to exhibit some of the more glaring anomalies of the implications of the global organisation of finance, such as the continuing net flows of capital from South to North.

Global capital inflows to developing countries halved from $1.6 trillion in 2007 to only $0.8 trillion in 2009. They have since recovered to $1.5 trillion in 2012. But – and here's the rub – capital outflows from developing countries also increased and also continued to be more than inflows. In 2012 such outflows amounted to $1.8 trillion. Just under half of this was in the form of reserve holding by central banks, but FDI, cross-border loans and portfolio investment account for increasing shares.

Most of the developing countries' foreign assets are in advanced countries, showing how perceptions of power continue to dominate financial decisions even in the developing world. There is much talk of increased South-South investment, and this has certainly increased. But it is still minor compared to the extent to which the developing world continues to finance the rich North, especially the US. Thus, while $12.4 trillion of foreign investment assets of the developing world are held in the North, South-South stocks of such investment are only $1.9 trillion – amounting to just 2 per cent of all cross-border foreign investment assets. So the developing world as a whole – and each one of the major constituent regions – continues to be net funder of the developed economies.

The largest impact of outward investment from developing countries is of course that of China. Certainly in absolute terms and in rate of growth, China's global financial presence has been significant. China is now a much larger funder than the World Bank in both Africa and Latin America, and its foreign direct investment has also been impressive in the last decade. But even so, China's investment abroad is dominated by the North. Thus around half of the total non-foreign exchange reserve holding of foreign assets by Chinese government and companies (around $1.5 trillion) is to other developing countries – but the

rest is in advanced countries. Meanwhile most of the foreign holdings are in the form of central banks reserves, which are currently estimated at more than $3.2 trillion. So foreign assets held in other developing countries still come to only around 15 per cent of China's total foreign assets. So even China, whose impact in the developing world is now so significant, still directs the greater bulk of its outward investment to advanced economies.

Meanwhile, the other concern is that many developing countries are trying to cope with the continuing ramifications of the global crisis by generating their own bubbles in domestic asset markets. This happens in a variety of ways: stimulus measures that target sectors like real estate and housing; other fiscal concessions granted to encourage more financial saving and investment; liberal rules for extension of consumer finance for purchase of durable goods; financial liberalisation measures that encourage more expansion of the sector; and so on.

These may create temporary mini-booms in certain economies, but these are temporary at best and in the current fragile external environment they may be even more short-lived. And the bursting of those bubbles will be even more painful in the context of the global economic headwinds. At the same time they will also encourage the same tendencies that continue to make developing countries export capital to the North, at the cost of meeting their own citizens' needs and fulfilling their own development projects.

So it is more important than ever to restrain finance, since that task is clearly incomplete. To make the financial system fulfil the basic tasks for which it is supposed to exist – to direct savings to productive investment in a stable and socially desirable way – it is essential to shrink it further.