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NORTH AMERICA

Understanding the financialisation of international development through 11 FAQs

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Financialisation is a contested term and historical phenomenon. Its driving force is **the creation** of new asset classes and the preservation of their real value to facilitate financial profits. Its core business model relies on generating profits from daily changes in the price of securities and commodities, held outright or via derivatives, and financed through repo markets. Financialisation stands for globalised financial capitalism, or financial globalisation. It re-engineers financial systems around securities and derivative markets, embedded in fragile and concentrated ecosystems of market-based banks and shadow banks. It generates increasing concentration within the financial sector, higher wealth inequality and more precarious labor. Through the World Bank's new *Maximising Finance for Development Agenda*, financialisation is colonising international development. In so doing, it reduces the space for alternative development strategies in developing and emerging countries (DECs).

Published by the Heinrich Böll Stiftung North America
Washington, DC, August 2018

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FAQ1. WHAT IS FINANCIALISATION?

Financialisation is often dismissed as a generic term with little meaningful content. Three dimensions - size, scope and concentration- are useful analytically to unpack it.

Size – the rise of finance

The most intuitive way to think about financialisation is size. One notices financialisation where the financial sector grows faster, or appropriates a larger share of profits than manufacturing or trading in goods and services. As Keynes noted, this rests on an organisation of economic and social life that secures maximum accumulation for the rentiers (the functionless investor that accumulates financial profits) at the expense of an equitable distribution of wealth, income and full employment. It involves financial liberalisation paving the way for complex and opaque financial products, and a hands-off regulatory approach that applies self-imposed market discipline as the main tool for preventing excesses in pursuit of financial profits.

To capture finance's footprint in the national economy, the simplest measurement draws on national accounting statistics for the FIRE (finance, insurance and real estate) sector. More sophisticated measurements have been introduced to capture new sources of systemic fragility such as shadow banking. Shadow banking is defined as activities similar to traditional banking undertaken by institutions that are not regulated like banks. This includes credit creation and intermediation by pension funds or insurance companies and their asset managers, deposit taking by money market funds. Most international institutions (such as the Financial Stability Board) start from country-level measurements to note that shadow banking has increased rapidly since the global financial crisis.

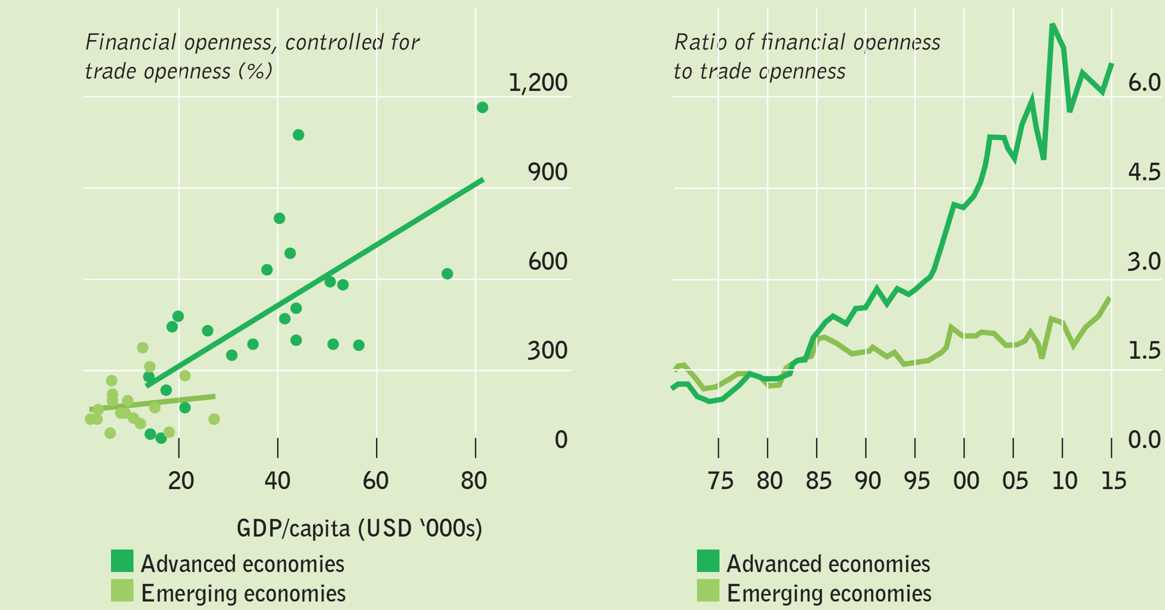
Scope – financial globalisation organised around securities and derivative markets

Given the availability of national account data, it is tempting to portray financialisation as essentially a national phenomenon. This is misleading. Rather, financialisation captures the systemic transformation of national forms of capitalism driven by financial globalisation. Financialisation is a global phenomenon, it thrives when finance can grow across borders, currencies and regulatory regimes, by creating new asset classes and partnerships with public authorities to preserve their real value.

This is immediately apparent when comparing the trajectory of trade and financial openness after the 1971 collapse of the Bretton Woods system, which set in motion the forces of financial globalisation (see Figure 1). Until the 1980s, both high-income and 'emerging' economies had roughly similar shares of trade openness (exports plus imports as share of GDP) and financial openness (foreign assets and liabilities as share of GDP). Put differently, cross-border financial activity was roughly similar to cross-border trade in goods and services, whether these originated from high income or other economies, as international trade requires cross-border financing arrangements. With the collapse of Bretton Woods, financial globalisation decouples from 'real' globalisation, at first in high-income countries, and since the global financial crisis, also in Developing and Emerging Countries (DEC). Cross-border financial links are created solely for financial purposes in financial networks dominated by global financial institutions that are globally systemically important. The importance of the global dimension of financial capitalism has been recently recognised through the term 'the global financial cycle', introduced by Helene Rey.[1] The global financial cycle, a phenomenon specific to financial capitalism, means that securities and equity markets across the world, capital flows and credit cycles are increasingly synchronised.

Figure 1: Financial vs real globalisation

Advanced economies have highers financial openness beyond GDP per capita or trade



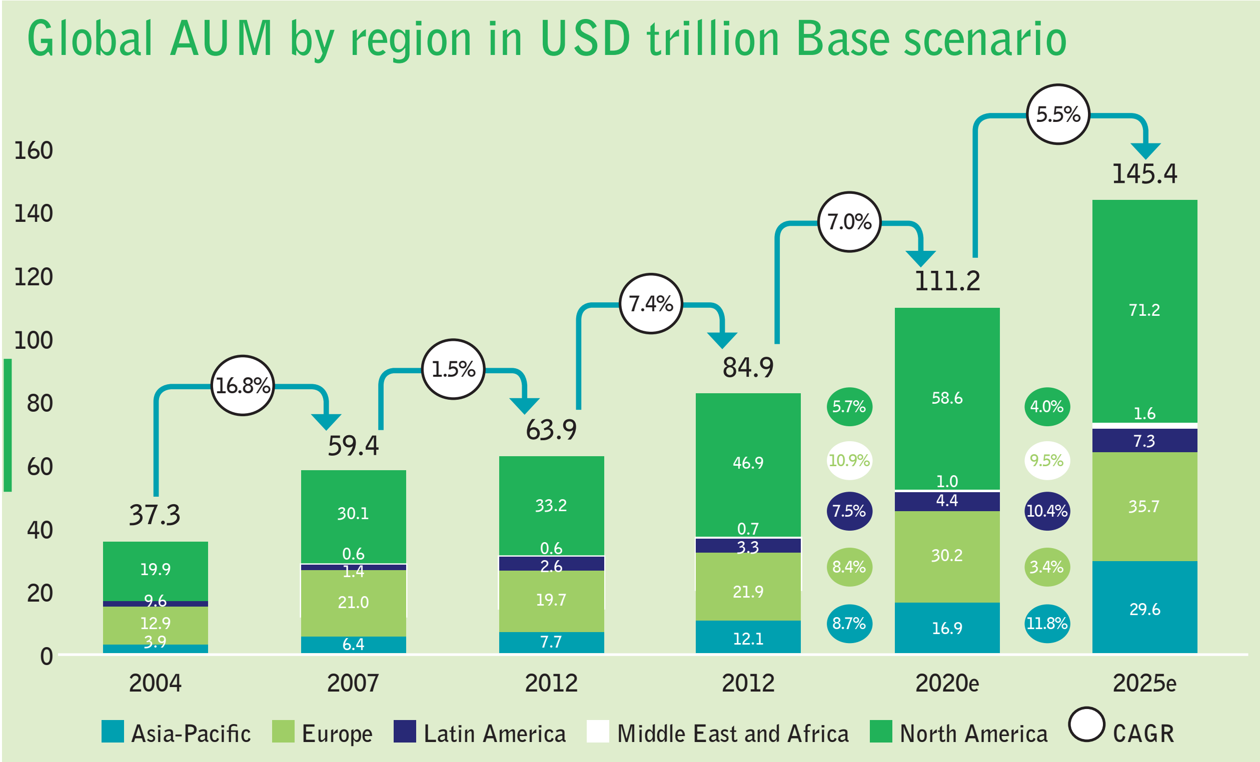
Source: https://www.bis.org/publ/arpdf/ar2017e6.htm

Thus, global financialisation is embedded in a complex ecosystem of financial institutions, banks and non-banks (institutional investors, asset managers, investment funds, other shadow banks), lending within borders to households, to companies and to each other (intra-financial sector activity), and trading within and across borders on securities and derivative markets, trading financed through wholesale money markets. Its temporal mark is shorter. Financialised capitalism is more impatient than relationship banking since financialised modes of profit accumulation require rapid entry in, and exit from securities, derivative and money markets.

The rapid pace of global financialisation is well illustrated by the growing importance of global asset managers. These are financial institutions that manage assets on behalf of institutional and retail investors. For retail investors, asset managers provide an appealing vehicle for investing in equity (and other asset) markets via passive index funds that track a stock market index.

The age of asset management[2] is here to stay, as it is expected that asset managers will account for a growing share of the global financial system. Its regional composition reflects the Global North-Global South divide, with asset managers from the Global North, particularly the United States, dominating the global distribution.

Figure 2 Global growth in assets under management (AUM)



Source: PriceWaterhouseCoppers, https://www.pwc.com/jg/en/publications/asset-and-wealth-management-revolution-putting-the-channel-islands-centre-stage.html

It is tempting to read the fast pace of financial globalisation as evidence of the expansive power of financial innovation left unchecked. This is however only one part of the picture. The other is a deliberate political choice, made in global policy communities and in national polities, to encourage the rise of market-based finance.

Three trends matter for mapping the political drivers of financial globalisation. The first is the growing shift from the welfare state to asset-based welfare, initiated under neoliberal pressures. This transition scales down citizens' ability to collectively provision for the future via the welfare state; it is accelerated by the austerity imposed to offset the public cost of global and national financial crises and the 'crisis' in public pension schemes in the context of unconventional monetary policies. However, it is important to note that financialisation in this guise bears little good news for (future) pensioners, as investment risk has been increasingly pushed from employers and financial intermediaries to individual investors, as for example in the structural shift from Defined Benefit towards Defined Contribution pensions. The shift to market-based protections via pension funds and insurance companies (and housing) thus increases the systemic importance of institutional investors, and their asset managers.

The second is the inability or unwillingness of states to deal with the tax revolt[3] of the elites, corporate and individuals. For instance, in the US, corporate income taxes fell from 27% of federal revenues in 1950, to 10.6% in 2015. Famously, Apple uses shell companies to shop around jurisdictions with low or no corporate tax regime. By 2018, its cash reserves increased to USD 280 billion, nearly six times the US development aid budget in 2017. Moral questions aside, tax avoidance by big corporations and high net worth individuals accelerates financial globalisation. As states across the world raise less in tax revenues, the elites accumulate wealth that is invested via global asset managers.

The third, a recent post-crisis trend, is for states and Multilateral Development Banks (MDBs) to embrace private finance as a solution to pressing social and environmental challenges. This is a dramatic change of direction from the early moments of the global financial crisis, when politicians around the world won elections by promising to reverse financial capitalism – by for instance creating, at unprecedented speed, a global regulatory regime for global (shadow) banks. By 2015 however, the mood shifted from 'working on finance' to impose significant structural changes that would make the global system more resilient to 'working with finance' to resolve pressing environmental issues, for instance in the European Commission's Sustainable Finance[4] initiative or the new ''Maximising Finance for Development'' agenda of the World Bank and other Multilateral Development Banks (see Section C of this document). The ambition, clearly spelled out, is that institutional investors and their asset managers could redirect their investment efforts towards assets with potentially positive social or environmental aspects, such as: green bonds, development impact bonds, and infrastructure bonds.

Concentration

The management of financialised capitalism is carved up among a small number of global financial institutions. These include global banks and more recently, global asset managers.

At first, financial globalisation benefitted a handful of transnational banks that shifted to a financialised business model, and came to dominate global banking networks. Financialised banks, or market-based banks, aggressively used leverage to embrace a new business model focused on: (1) the production and proprietary trading of securities (through securitisation and off-balance sheet derivative positions), (2) making markets in securities and derivatives, and (3) global management of assets and liabilities. When their role as 'super-spreaders'[5] of global systemic risk became apparent in the global financial crisis, the global regulatory community abandoned its erstwhile lax rules. They introduced Basel III rules that specifically target banks' market activities (via leverage and liquidity restrictions, such as loan loss provisions), alongside national rules like the Volcker Rule, which separates depository banking from speculative activities. These rules have failed to generate a structural shift in banks' business model.

The rise of asset managers marks a new stage of concentration in financial capitalism. Asset management is even more concentrated then transnational banking. The Big Three asset managers – Blackrock, Vanguard and State Street - together manage nearly USD 11 trillion. This is three times larger than the global hedge fund industry, and roughly equal to the entire GDP of the Eurozone for 2016. The Big Three together are the largest shareholders in 80% of US stock market listed firms. Concentrated asset management relies on the services of market-based banks for access to financial markets infrastructure, and, importantly for their business model, for securities financing transactions.

FAQ2. WHO IS THE SPECULATOR?

Degrees of speculation: Where is the line between speculative and patient investors among hedge funds, private equity funds, on the one hand, and pension, insurance, and sovereign wealth funds, on the other? Does the Volcker Rule which attempts to build a wall between commercial and investment banking represent this line?

It is common to distinguish between financial institutions that use leverage (hedge funds, bond funds, investment banks) and 'real money' institutions (pension funds, insurance companies, sovereign wealth funds, money market funds) that do not rely on debt to increase their balance sheet.

Financial capitalism is blurring the line between speculative and patient investors. Real money investors are typically described as patient investors. Patient investors purchase securities with client money (for example a retail investment fund) and typically hold these securities to maturity (see Figure 2). A security is the equivalent of a loan, with predefined maturity and interest rates. For example, the owner of a government security, or bond with a two-year maturity and a 2% coupon, can expect to receive back the money it lent to the government at the end of the two years, and interest payments annually. The range of lenders via securities markets includes foreign and local institutional investors (pension funds, insurance companies), asset managers and sovereign wealth managers, and leveraged investors, such as hedge funds and banks.

Figure 3 Assets and liabilities for a patient investor

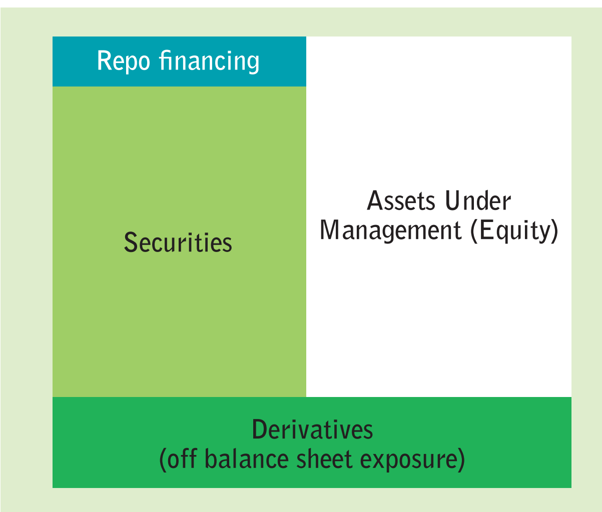
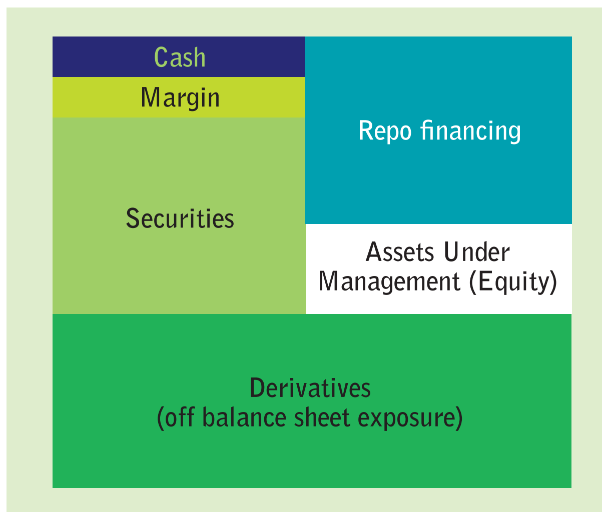


Figure 4 Assets and liabilities for an impatient (speculative) investor



*Source: adapted from Avalos et al (2015)**

Avalos, F., R. Moreno and T. Romero (2015) Leverage on the buy side, BIS Working Paper no. 517.

Leveraged investors are said to be speculative in their activity, entering and exiting securities and derivative markets rapidly in their chase after yields. To do so, they combine *funding leverage* (outright borrowing) and *instrument leverage* (derivative positions). They finance securities by borrowing against them in short-term repo markets, by unsecured borrowing from banks, or (less common) by issuing their own securities (see Figure 3). They may lend some of their cash overnight in repo transactions, for which they receive margin. They use derivatives to amplify exposure to assets without outright owning them. For instance, data for 2014 shows BlackRock's Fixed Income Global Opportunities fund had an average leverage of 746%, Pimco's Global Bond fund had 486% and Goldman Sachs's Global Strategic Income Bond Portfolio 674 % respectively.[6]

In practice, financial capitalism is increasingly blurring the line between speculative and patient investors, despite the provisions of the Volcker Rule. Business models are converging towards an impatient model whereby financial profits are increasingly reliant on daily variation in the price of securities, held outright, via ETFs or via derivative positions. The Volcker Rule for instance treated banks' short-term trading positions as profit-seeking (read speculative) unless banks could prove otherwise. The short-term model is possible because lending via capital markets allows the lender to dispose of securities before maturity through secondary markets, where investors trade securities already issued. In order to take advantage of short-term changes in the market price of securities, investors require liquid secondary markets that allow them to easily create or liquidate securities positions without large movements in price. It is no coincidence that the alchemy of financial capitalism revolves around engineering market liquidity.

Rise in Speculative Activity

There are three ways in which 'patient' investors are increasingly converging towards the speculative model. First, it is well known that institutional investors (e.g., pension and insurance funds) allocate a part of their investment directly to hedge funds with less regulatory restrictions on portfolio allocation, and therefore higher potential returns, at least in theory. For instance, estimates for 2017 suggest that (mainly US based) pension funds accounted for 42% of all money flowing into the global hedge-fund industry.[7] Second, institutional investors provide financing for leveraged funds, directly by lending cash against securities collateral in repo markets, or by lending securities to investors betting on short-term movements in price (shorting, see Figure 4). Third, 'real money' investors like pension funds are increasingly turning to leverage. With unfunded pension commitments, it is likely that the pension funds across the world will follow in the footsteps of Canadian pension funds that are allowed to use short-term leverage via repo and derivative markets.[8]

Figure 5 Evolving business model of real money investor

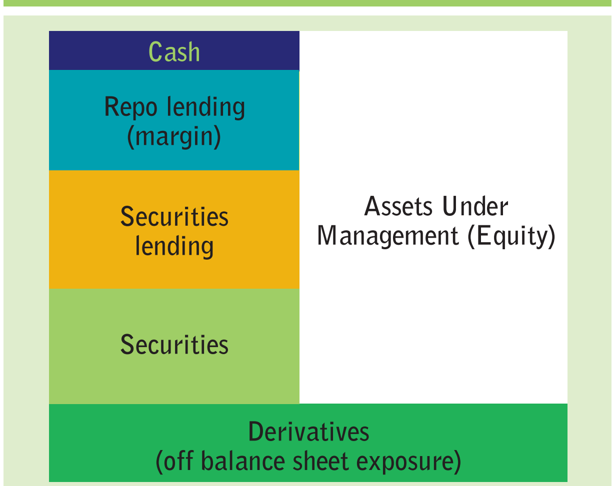
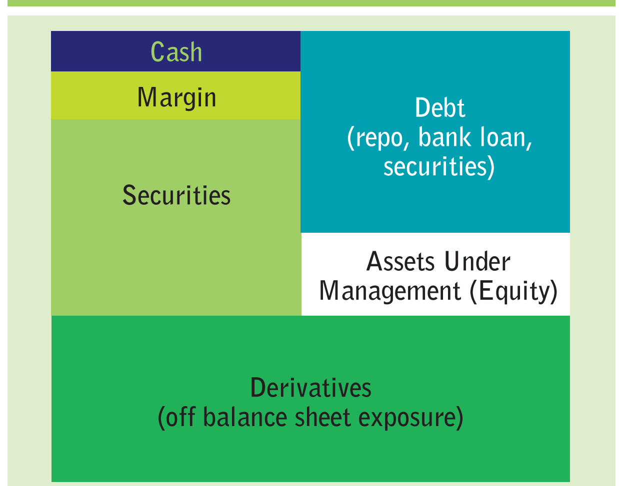


Figure 6 Business model of speculative investor



The convergence in business models organised around daily moves in securities and derivative markets also matters for developing and low income countries. While the conventional wisdom is that asset managers, with the exception of hedge/bond funds, do not use leverage (outright borrowing as opposed to managing assets of other investors), recent research suggests that asset managers are increasingly relying on leverage when investing in DEC securities markets, and can therefore be a threat to financial stability.

FAQ3. WHICH COMPLEX FINANCIAL PRODUCTS MATTER?

Financial globalisation typically supports 'innovation' of complex, often poorly understood, financial instruments that aim to increase the pool of tradable assets and the preserve their real value. Those that matter have a large debt component (enabling aggressive leverage) that creates new systemic connections across borders and markets.

Contrary to public imagination, few innovations become immediately systemic. The post Bretton Woods age of financial globalisation has created two such systemic financial products that enable finance to shift risk and free up capital:

A. Securitised debt

Securitisation involves the creation of tradable securities out of illiquid loans. Loans are repackaged into standardised products that can receive a credit rating and can be traded in secondary markets. The loan originators sell the rights to the loans to a Special Purpose Vehicle (SPV), that is neither treated as a subsidiary nor affected by the insolvency of the originator. The SPV issues a tradable asset or several tradable assets (tranching) that are sold to investors. The cash flows from the underlying loans are directed to the owners of the new securities. Originators prefer tranching that divides the securities into different classes with different credit ratings, and can thus be sold to a broader range of investors. Tranches establish the priority of payment of principal and interest from the underlying loans, and therefore carry different interest rates. The AAA rated tranche has priority of payment over mezzanine and junior tranches, and therefore will yield a lower interest rate to match its (relatively) safer profile.

Tranching is also important for creating new securities known as Collateralised Debt Obligations (CDOs). These are structured products that purchase and pool tradable assets (as opposed to illiquid loans) such as the riskier tranches of asset and mortgage backed securities, in order to issue securities in tranches that can then be repackaged. The aim is to recycle those tranches that cannot easily be sold to investors into higher-rated products, with the help of credit rating agencies.

B. Derivatives

Derivative markets, where financial and non-financial institutions can hedge risk or take additional leverage, are of interest where they become a direct source of systemic risk. The most pertinent example is offered by Credit Default Swaps (CDSs) used to provide insurance on CDOs prior to the global financial crisis. The issuers of CDS provided a guarantee on the viability of CDOs – that were shifting risk from the subprime lender to the mortgage-backed security (MBS) tranche to the CDO tranche - against a premium. The issuance of CDS was viewed as a risk-free capture of premium, since the assumption of the underlying models was that house prices would continue to increase, and therefore CDOs would continue to generate cash flows even when subprime borrowers defaulted. The perception of risk-free financial profits incentivised the issue of naked CDS[9] that provided guarantees against default to institutions with no material exposure to CDOs or other underling structured products. US regulators sanctioned these instruments by allowing issuers to rely on regulatory loopholes that provided exemptions from capital requirements.

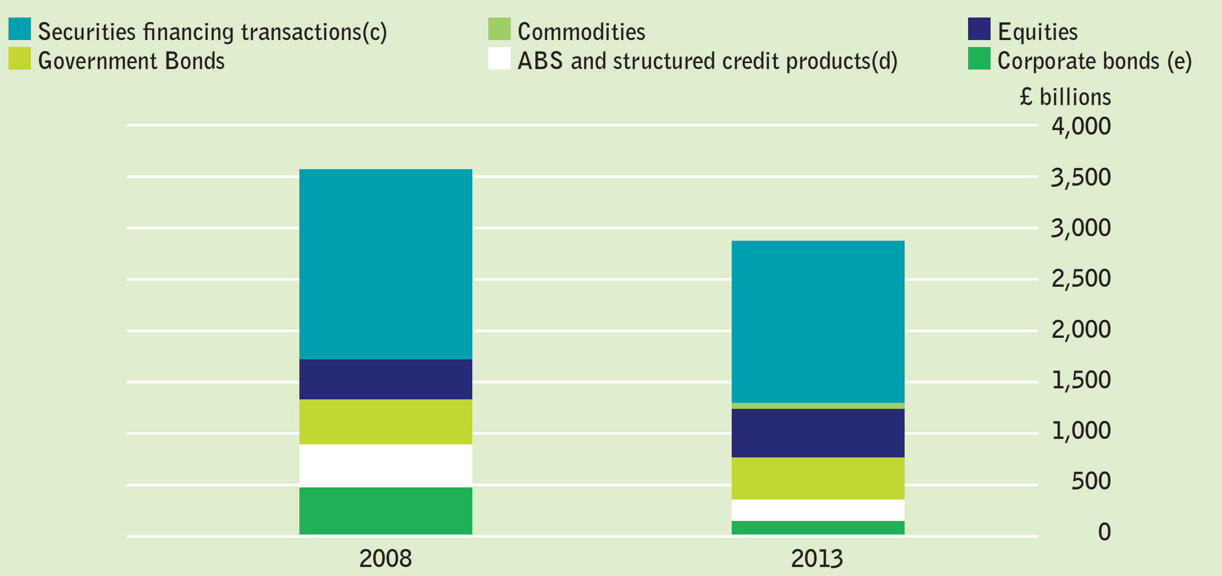
C. Securities financing transactions (SFT or repos)

Repo markets are important. "Repo" is short for repurchase agreement, and is also know as a securities financing transaction. Those who deal in government securities use repos as a form of overnight borrowing. A dealer or other holder of government securities (usually T-bills) sells the securities to a lender and agrees to repurchase them at an agreed future date at an agreed price.

Repo markets play two critical functions in financial capitalism. First, repo markets are wholesale funding markets where financial institutions can finance their securities portfolio on cheap funding terms.[10] The mechanics are simple: a borrower transfers legal ownership of the securities (known as collateral) to a lender and promises to repurchase that security at maturity of the repo loan. However, the borrower retains economic ownership of those securities, that is, the risk and return associated with those securities. The lender receives an interest rate on the repo loan, and can sell those securities in case the borrower defaults. The presence of collateral renders the repo loan cheaper than an unsecured loan. Second, repos are necessary for shorting securities, as they allow financial institutions to borrow securities they do not own.

Securities financing transactions are central to financialised business models that seek financial profits from daily changes in the price of securities. Repos account for a large share of global investment banks' assets held for trading, significantly higher than government bonds or corporate bonds (see Figure 6). It is likely that the statistics, produced by the Bank of England, underestimate the actual gross volumes of securities financing transactions that are often netted through central clearing counterparties.

Figure 7 Global banks' assets held for trading and securities financing transactions



Sources: Published accounts and Bank calculations.

(a) Sample as in Figure 2, with the addition of the Royal Bank of Scotland and exclusion of Deutsche Bank. 2008 data include assets held by investment banks that were acquired by these groups during the crisis.

(b) Assets held for trading exclude derivatives.

(c) Securities financing transaction assets are adjusted for differences in accounting standards between US and European banks. IFRS accounting standards are used for this chart.

(d) Includes traded loans.

(e) Includes money makets instruments.

Source: Bank of England[11]

Repos are structured legally to orient (shadow) bankers towards the daily market value of collateral. For both borrower and lender, the daily market value of the security collateral is critical: the borrower does not want to leave more collateral with the lender than the cash it has borrowed, and vice-versa. The practice of mark-to-market allows repos to feed aggressive leverage during good times – when securities prices go up, the borrower gets cash/securities back, and can borrow more against them to buy more securities, drive their price up,[12] etc. Conversely, when securities prices fall, borrowers have to find, on a daily basis, more cash or more collateral. When they cannot, firesales ensue, shattering the illusion of securities market liquidity that is created by cyclical repo financing.

In sum, securitised assets, derivatives and repos/SFTs are defining features of financial globalisation, understood as the growing importance of financial profits accumulated through business models reliant on daily changes in asset prices. Securitisation is used to create new asset classes that can be easily sold to a broad range of investors with different risk preferences. Derivatives allow investors to hedge or magnify exposure to structured products and other securities. Repos in turn allow both originators and final investors to finance securities at minimum cost and maximum leverage. Together, these instruments create a more fragile (global) financial system, one that is cyclically vulnerable to large swings in asset prices, and to financial instability. It is no coincidence that the global financial crisis started in securitisation markets (CDOs involving subprime mortgages) and was propagated through repo markets across the balance sheets of large, interconnected global financial institutions. Losses from CDOs made up for nearly half of the total losses sustained by financial institutions between 2007 and early 2009, while the collapse of Lehman Brothers triggered a run on global repo markets that ignited the banking and then sovereign debt crisis in Europe.

The global policy community recognised the systemic role of these three financial instruments. The Financial Stability Board, created in the wake of the crisis, identified the reform of securitisation and repo markets as two critical priorities of the shadow banking reform agenda.

Paradoxically however, securitisation is back on global and regional policy agendas. Since 2015, regulators and politicians have identified securitisation as a solution to ongoing bank credit rationing in Europe through the Capital Markets Union project and to developmental challenges that can be solved by connecting institutional investors with bankable development projects such as infrastructure building. Thus, the Group of 20 (G20) Eminent Persons Group proposes that MDBs assist countries in meeting their development financing needs via securitisation. Securitising across the MDB system would create new asset classes attractive to institutional investors.

FAQ4. FINANCIALISATION AND THE REAL ECONOMY?

What is the relationship between the financial sector and the real economy and what are the mechanisms that extract resources from the real economy?

It is useful to specify first what a non-financialised economy looks like. In the simplest terms, its financial sector is dominated by banks engaged in lending long-term for productive activities. This is a capitalist economy best described in Keynesian terms, where the banks dominating the financial sector facilitate the accumulation of industrial profits (often guided by industrial policies), where cross-border financial activity is repressed by well-functioning capital controls and structural limits on volatility such as the Bretton Woods system of fixed exchange rates, and where the central bank is an outpost of the state in private finance. Bank-based systems do have securities markets, and where these work well, they serve to finance the long-term capital needs of companies. Indeed, an alternative model of organising credit creation in capitalist economies is via securities markets. A de-financialised model of market-based finance is one where corporations issue securities to finance long-term capital investment by patient investors (including banks) that hold these securities to maturity. Credit creation in this model serves the real economy when the lender's profit expectations reflect the performance of the borrower; this fosters a buy-to-hold strategy as opposed to one based upon the performance of the security.

A non-financialised banking model has its shortcomings. Private banks are often too averse to financing risky innovative projects that would push countries upwards in global value chains. In response, states may decide to step in, through development banking. Most countries with a successful experience of industrialisation (Korea, Japan, China, India, Brazil, the US and France) relied on public development banking as a critical pillar of industrial policies.[13] Public development banking allows the developmental state to provide subsidised long-term loans to industrial sectors identified as strategic by an industrial policy aimed at promoting the international competitiveness of local firms.

A financialised banking model stands in stark contrast to development banking. Financialised banks increasingly migrate from their long-term relationships with the productive sector to activities in securities and derivative markets, and to lending to households for consumption and housing. The subprime lending model is one illustrative example of such shifts in bank lending practices. This typically deprives the manufacturing sector of credit for long-term capital investment, and generates macroeconomic imbalances as consumer credit and housing bubbles increase demand for imports.

Financial systems organised around securities markets are more prone to financialisation. It is simply easier and faster for speculative investors to chase yields in market-based financial systems. The key is to create liquid secondary markets. Liquid secondary markets are necessary to validate financialised business models that generate profits from daily variation in the price of securities, either by owning the security outright, or by taking a derivative position on movements in its price, as described in the previous section.

The traditional, still dominant, architecture for organising secondary market liquidity involves market-making banks. Market-makers quote prices two ways: the price at which they are willing to buy a security, and the price at which they are willing to sell. Market makers obtain profits from the buy-ask spread. Market makers have essentially two ways in which they meet demand for securities in secondary markets: by purchasing on their own account and by borrowing those securities. Both methods require deregulated wholesale funding markets and derivative markets.

Financialisation thus generates two main mechanisms for extracting resources from the real economy. The first, a *slow extraction*, arises from the more expensive terms on which finance makes credit available to the 'real' economy that requires it for both working capital and for long-term investment (except for a handful of large corporations that accumulate large pools of cash). Here it is well-documented that financial metrics and shareholder value shape the behavior of large corporations at the expense of long-term investment decisions that would drive innovation and sustainable economies in periphery regions within the North or in the Global South. It is also well-documented that small and medium firms face restricted access to finance and prohibitive interest rates in countries where banks increasingly embrace the securities market-based model. Banks with market power, with less stable funding sources, and weaker balance sheets impose higher costs on SME loans.[14]

The second mechanism is *fast extraction*. The impatient business model described above feeds, through leverage, generalised increases in asset prices, or what is now known in policy circles as the global financial cycle. A surge in capital flows, driven by global banks or global asset managers in search of short-term yields, increases prices of securities and stocks across high and low income countries. Retrenchment of capital flows leads to steep declines in asset prices that can easily morph into a systemic crisis. As the IMF, traditionally a strong promoter of financial capitalism, recognises, global factors can become more important for domestic financial conditions than domestic policy.[15]

Financialisation hardwires an illusion of liquidity into securities-based financial systems. This renders them significantly more vulnerable to systemic risks than bank-based financial systems. Foreign investors prefer liquid local securities markets that facilitate ease of entry and exit, and therefore a business model anchored in daily movements in the price of securities. For this, foreign investors demand market infrastructures that accommodate short-term positions, including liberalised repo and derivative markets so that securities can be financed or shorted without regulatory obstacles (see Box 1). However, such demands for re-regulation along the lines preferred by global finance downplay the structural vulnerabilities that come with this new lending and financing model.

Box 1 Indian bond markets – a view from the Association of Securities and Financial Markets in Asia (ASIFMA).

In a 2013 report, ASIFMA identified several bottlenecks in the rapid development of local bond markets, bottlenecks that reduced significantly the interest of foreign investors.

1. *Hold to maturity bias:* local banks held around 80% of government bonds in hold-to-maturity portfolios. This 'patient' strategy, strongly influenced by liquidity regulations, reduced the volume of bonds available for trading in secondary markets, and therefore market liquidity.

   The finance lobby recommended the removal of prudential regulations.

   Since then, Indian banks have increasingly shifted their portfolios of government bonds into 'held for trading', leading to quiet conflicts with foreign banks betting on price moves that expose state-owned banks to losses from those price movements.[16]

2. *Liquid repo market:* market-makers cannot short securities, and thus provide secondary market liquidity, because the legal framework does not allow for the legal title of collateral to be transferred in a repo. Collateral securities cannot be re-used.

   The finance lobby recommended aligning the legal framework with European/US standards.

3. *Active liquid derivative markets:* foreign investors can only hedge the currency exposure resulting from ownership of local currency securities through non-deliverable swaps (NDSs) outside India (offshore NDSs).

   The finance lobby recommended the development of onshore derivative markets, arguing this would increase the liquidity of securities markets.

When such new market infrastructures are put in place, local securities markets appear liquid in the upswing of a global financial cycle due to increased demand and trading. But securities market liquidity can easily disappear as global investors retrench. This is why central banks routinely voice concerns about the illusive nature of securities market liquidity.[17] Falling securities prices renders leveraged investors vulnerable to short-term funding pressures, and confronts policy makers with a dilemma – let leveraged investors fail, but at the potential expense of a systemic crisis (in the global financial crisis, the fall of Lehman Brothers triggered such a liquidity spiral). Given the serious political and social consequences of an implosion in the financial sector, politicians typically choose to bail out leveraged investors by allowing them access to emergency liquidity lines from the central banks and by propping up securities prices. The new securities market-maker of last resort function adopted by central banks is thus providing a safety net for financialised banks and shadow banks, ensuring that the market value of their securities does not collapse. Thus, the market-maker of last resort and fiscal resources re-directed to recapitalising banks affected by their activities in securities and derivative markets are two central mechanisms through which financialised investors engage in the fast extraction of resources from the real economy.[18]

FAQ5. FINANCIALISATION AND THE ECONOMIES OF DEVELOPING COUNTRIES?

What do the efforts to deepen national capital markets look like? What kind of trade-offs and trends do we see between domestic and foreign debt?

Financialisation is not a phenomenon exclusively associated with complex innovation in highly developed financial markets. Financialisation also affects countries with 'shallow' financial markets that open their capital accounts and/or encourage transnational financial actors to set up subsidiaries or branches. These often become a powerful political force, able to navigate uneven regulatory and institutional terrains in order to create new modes of profit generation.[19] The incorporation of developing countries in financial globalisation can be understood through the lens of dependent financialisation.

Dependent financialisation captures the re-engineering of local financial systems towards capital (securities) markets through a partnership between transnational financial institutions seeking new asset classes/sources of yield and poor countries seeking financial market-solutions to political problems. The presence of financialised global (shadow) banks may crowd out credit creation for the development of local productive capacities. It also locks DECs into the dynamics of global financial cycles, limiting significantly their ability to influence domestic financial conditions. This partnership is anchored in trading-based modes of profit generation for transnational financial actors.

The roots of this partnership pre-date the global financial crisis. In the early 2000s, the Group of 8 (G8) countries - led by Germany's central bank, the Bundesbank, together with the World Bank and the IMF – announced a new strategy to promote local currency bond markets as a solution to the systemic vulnerabilities that DECs closely engaged with financial globalisation had experienced in the 1990s. The G20 countries reinvigorated the plan in 2011, and instructed the FSB to reorient the global agenda of reforming shadow banking towards a project of constructing resilient market-based finance.[20] As one Bundesbank official put it in 2011 "more developed domestic bond markets enhance national and global financial stability. Therefore, it is not surprising that this is a topic which generates an exceptional high international consensus and interest even beyond the G20".

Deeper local securities markets, it is argued, would (a) reduce DEC dependency on short-term foreign currency debt by (b) tapping into growing demand from foreign institutional investors and their asset managers while (c) expanding the investor base to domestic institutional investors that could act as a buffer, increasing DEC's capacity to absorb large capital inflows *without* capital controls; and (d) reducing global imbalances, since large DECs (read China/other Asian countries) would no longer need to recycle savings in US financial markets. Everyone wins if DECs develop missing (securities) markets.

Despite paying lip service to the potential fragility of capital flows into DEC securities markets, this is a project of policy-engineered financial globalisation, or dependent financialisation. It encourages the entry of foreign financial institutions with trading-based modes of profit generation. These not only create new mechanisms of extracting resources, but also fundamentally change the shape of local financial systems. Transnational financial actors create new relationships across local currency markets, local capital markets and international wholesale funding markets. These relationships are *transformative*, financialising various market segments by integrating them in the global financial cycle.

- *financialised* currency markets that no longer reflect international trade in goods and services but capital flows driven by cross-currency risk appetite (known as carry trades) determined by the global financial cycle.[21]
- *financialised* interbank money markets that no longer reflect demand for, and supply of, central bank reserves arising from traditional deposit taking and lending activity but instead the interplay of capital inflows and central banks interventions on currency markets to prevent excessive appreciation of the domestic currency.
- *financialised capital markets:* foreign and domestic lenders' profit strategies are embedded in the daily performance of the securities and subject to the rhythms of the global financial cycle as opposed to domestic financing conditions and the economic performance of borrowers.
- *financialised funding models:* efforts to deepen local capital markets focus on the simultaneous creation of securities financing markets where foreign and local investors can finance or short securities, from government bonds to corporate bonds and structured products.
- *financialised* commodity markets: large scale participation of global financial investors in derivative markets and the shifting business model of international trading houses that transforms commodities into an asset class, trickling down to change national physical markets in which commodity chains are embedded (see Staritz et al 2018)

Markets became financialised quantitatively (rapid growth, cyclically liquid) and qualitatively (structural changes in demand/supply conditions driven by trading-based models).

Dependent financialisation reduces national policy autonomy and ties the dynamic of local asset markets into the interest rate decisions of main financing centres and the balance sheet decisions of a handful of global financial institutions – global banks and global asset managers. Through dependent financialisation, local markets become more sensitive to global financial conditions. Dependent financialisation requires significant increase in state capacity to manage countries' integration in global financial cycles via macroprudential policies and capital controls, thus diverting bureaucratic resources from designing alternative development models to managing the vulnerabilities of financial capitalism. Dependent financialisation makes it increasingly difficult to create alternative development models where state development banks and local patient actors play a greater role in the allocation of credit.

FAQ6. FINANCIALISATION AND THE LIVELIHOODS OF PEOPLE IN DEVELOPING COUNTRIES?

How are the lives and livelihoods of people in developing and emerging market countries affected by financialisation? How much do we know about the "inequality effects" of financialisation (as returns increasingly go to the sliver of people who own stocks, and the investment firms that do the deals)?

The forces of financialisation are easily noticeable in high-income countries. The financialisation of every day life captures the increasingly large footprint that finance leaves on daily life through dynamics such as (a) the proliferation of financial products that are acquired to deal with future uncertainties no longer mitigated by the welfare state (home mortgages, private health insurance, pensions and stocks market shares) and (b) the increased bargaining power of capital that keeps real wages from increasing, forcing workers to become indebted in order to maintain living standards. Furthermore, the financialisation of everyday life is uneven and sharpens inequalities.

Gains from financial globalisation are unevenly distributed. Those at the top of the income distribution benefit from their increased bargaining power in the labour market and from safety nets put in place to preserve the real value of financial assets (from quantitative easing to market-maker of last resort). In contrast, those at the bottom of the income distribution have limited access to finance, and serve as a source of financial profits, as for example through subprime mortgages, or, more recently, through unsecured personal loans. It is no coincidence that the rise of financial globalisation has been accompanied by a rapid increase in income inequality and a broad stagnation in real income for workers and wage earners in OECD countries.

These developments stand in stark contrast with the optimism of the 1990s portraying the 'citizen as investor' and as the agent for the 'democratisation of finance' (Shiller, 2003). It throws into question the celebratory discourse of 'financial inclusion', with its claims that everyone would learn to manage balance sheets in their increasingly complex engagement with financial markets, and with its assumptions that light regulatory touches and individual financial literacy would work to curtail financial predatory practices.

The forces of financial globalisation affect the lives and livelihoods of people in developing and emerging countries in distinctive ways. The financialisation of everyday life is less prominent than in high-income countries as fewer have access to the formal financial system. Those that do have access are typically targeted by global banks and shadow banks in a regime of asset-based welfare, where middle class families save via mortgage housing, insurance and pension funds. Those excluded are increasingly targeted by new strategies of digital financial inclusion via digital footprints that will gradually connect the poor to global finance via securitisation.[22]

The gains from dependent financialisation are more fragile for those households engaged in asset-based welfare, as illustrated by countries in Eastern Europe. There, transnational banks extended mortgage loans in foreign currencies (Swiss francs, Japanese yen, Euros) and transferred exchange rate risks to borrowers. When financialised currency markets were affected by the downswing in the global financial cycle, borrowers saw their foreign currency interest and nominal payments increasing rapidly to unsustainable levels.

The on-going efforts to engineer a deeper integration of DECs in global finance will further expose the livelihoods of people to the vulnerabilities of dependent financialisation in four ways.

(a) dependent financialisation may change the relationship between the financial system and the real economy, potentially reducing the credit available to local companies, and therefore the demand for sustainable jobs. It may thus worsen, rather than improve, the precarious nature of labour markets in poor countries.

(b) dependent financialisation may also encourage states to divert fiscal resources into creating the financial infrastructure to attract foreign institutional investors, by for instance supporting system-wide risk insurance, as envisaged by the G20 Eminent Persons Group, or by providing subsidies, as envisaged by the Cascade Approach underpinning the World Bank's Maximising Finance for Development agenda.

(c) dependent financialisation severely limits the capacity of domestic polities to provide the public good of macroeconomic stability, by tying the evolution of domestic financial conditions into the vagaries of global financial cycles and the interest rate decisions of large countries, particularly the US.[23] This limits the ability of states to provide countercyclical safety nets via the welfare state, and to stabilise aggregate demand.

(d) dependent financialisation reintroduces the privatisation of public services through the back door. It normalises the idea that public goods – education, health, infrastructure – can be provided by private entities and financed by institutional investors via capital markets. Development financing is thus redirected towards securing the profits of private companies and private finance.

FAQ7. WHAT ARE KEY LEVERAGE POINTS TO FIGHT THE WORST INJUSTICES OF FINANCIALISATION?

Financialisation, or financial globalisation, rests on an organisation of economic and social life that secures maximum accumulation for the rentiers (the functionless investor that accumulates financial profits) at the expense of an equitable distribution of wealth, sustainable growth and full employment. To slow its advance, or the most ambitious project of reversing, would require a concerted, systematic strategy along the following points of leverage:

• Patient banks not impatient profits

Target the core business model in financial capitalism of chasing short-term profits from daily changes in price of securities and derivatives positions, including by Financial Transaction Taxes on securities financing transactions and derivatives (using the model of the European Commission proposals) and by tighter regulatory regimes for banks and shadow banks (asset managers).

• Make finance local again

Revive plans for structural separation of retail from investment and shadow banking, since finance remains too big, too politically powerful and too distant from everyday lives of ordinary people.

• Financial inclusion through the state, not fintech

Fintech companies are those combining digital technologies with financial activities. Silicon Valley companies dominate the global fintech sector, although China is developing a significant local competitive base. In recent years, an alliance between fintech companies, philanthropic investment companies and national regulators in emerging and poor countries, known formally as the Alliance for Financial Inclusion, has sought to harvest the digital footprints of the poor, under the logic of 'all data is credit data'. This would allow them to use digital footprints in order to create credit profiles for poor citizens without formal collateral.[24]

• Collective welfare not asset-based welfare

The shrinking footprint of the state in the economy gives incentives to the forces of financial globalisation. (Re)nationalise pension funds and state funding for health, education and infrastructure, which would reduce the systemic importance of institutional investors and concentrated asset management. This helps prevent the acceleration of financial capitalism where states withdraw from the provision of public goods.

• Reduce tax avoidance, slow down financialisation

The rise of institutional cash pools is an important aspect of this age of asset management. It reflects in part the inability or the unwillingness of the state to tax multinational corporations and high-net worth individuals. These in turn use shadow banking to find safe and/or profitable placements for their accumulated wealth.

• Domestic financial conditions under domestic control

Develop a capital controls toolkit for DECs, designed and continuously updated by the IMF and autonomously implemented by DEC countries.

- **Stop re-engineering DEC financial systems towards market-based finance**

This renders them more vulnerable to global financial instability and limits space for autonomous developmental models.

FAQ8. HOW DOES THE WORLD BANK GROUP FURTHER FINANCIALISE DEVELOPMENT?

The financialisation of development, embedded in a technocratic management of poverty, captures the mainstreaming of the idea that private finance can be the solution to pressing developmental concerns. In a first stage, set in motion by the World Bank's push for global financial inclusion as a new development paradigm, the financialisation of development rested on a promise that fintech-powered digital financial inclusion would generate employment, support entrepreneurship and increase prosperity in low-income countries. A new strategic partnership between fintech companies, philanthropic investors and international development agencies is now working to monetise the digital footprints of the very poor. With this, global finance seeks to harness the digital revolution in financial inclusion towards financialised aims and business models, profiling the poor into generators of financial assets that can be eventually securitised.

The World Bank's Maximising Finance for Development (MFD) strategy marks a new stage in the financialisation of development. The MFD suggests that poor countries can no longer achieve the Sustainable Development Goals (SDGs) with their own budgets and (increasingly scarce) donor funding. Instead, in order to mobilise the estimated USD 5 trillion gap to reach the SDGs, it asserts that this public money should leverage private finance, particularly the deep wallets of institutional investors. The 2017 MFD strategy re-brands the 2015 *Billions to Trillions: Transforming Development Finance* paper that announces how the multilateral development banks (MDBs) will collectively increase financial leverage via securitisation in order to catalyse private investment. It also responds to the G20's "Principles of MDBs' strategy for Crowding-in Private Sector Finance for growth and sustainable development" (April 2017).

The World Bank is piloting the initiative in many sectors and 9 countries Cameroon, Cote d'Ivoire, Egypt, Indonesia, Iraq, Jordan, Kenya, Nepal, and Vietnam. For infrastructure sectors, such as energy, transport, and water, the G20 "Roadmap to Infrastructure as an Asset Class" spearheads the MFD. Use of guarantees will be crucial in de-risking projects. For example, in Kenya, the World Bank is preparing an IDA guarantee to increase the attractiveness of public-private partnership (PPP) projects and their sustainability. To attract long-term institutional investors, the MFD initiative will promote capital markets where bankable projects can be transformed into liquid securities. The guarantee, it argues, will crowd in local institutional investors to provide patient local currency funding via capital markets.[25] For this purpose, the International Finance Corporation (IFC) also plans to help finance the development of capital markets infrastructure, as it did in Colombia.

The MFD strategy aims at the large-scale reorganisation of development interventions via capital markets (green bonds, social impact bonds, ESG bonds,[26] infrastructure bonds). The claim is that capital markets can provide new solutions to age-old development challenges (inadequate infrastructure, homelessness, access to education, clean water, crime prevention and helping disadvantaged children). Securities markets can connect foreign and local institutional investors that care about social/environmental impact with those in need of support. The process of 'building movements of belief' through institutional investment is expected to achieve the SDG development goals.

The MFD is less transparent about the strategy than it is about the tactics. The overall strategy is to policy-engineer a shift towards securities-based financial systems and thus render DECs more amenable to the forces of financialised capitalism. The strategy has gathered momentum since the global financial crisis through several other initiatives. The Local Currency Bond Market Initiative, designed by the World Bank and the IMF at the request of the G20, invites DECs to foster liquid local currency securities markets that can attract foreign investors. The Financial Stability Board has proposed measures to transform shadow banking into resilient securities market-based finance. In the Global North, the European Commission is promoting a new Sustainable Finance initiative that intends to reorient institutional investors and asset managers towards sustainable activities. In creating a framework for sustainable investment, such initiatives will also trigger beneficial market mechanisms, incentivising companies to use environmental, social and governance performance criteria in their core business model if they wish to attract sustainable financing.

To guide the MFD strategy, the World Bank developed the Cascade approach in order to institutionalise a preference for private financing of development. Its premise is that there are *market imperfections or missing markets* that prevent the private sector from capturing the externalities of development projects and therefore financing them. The Cascade proposes a sequence to identify these structural bottlenecks: 1) identify Reforms (regulatory or other policies) that would allow the private sector to internalise externalities (a highway toll for instance); 2) if reforms insufficient, then identify Subsidies and Guarantees to de-risk the project; 3) if reforms and subsidies are still not enough to attract the private sector, then 4) opt for a fully public solution.

The Cascade approach, as spelled out in a World Bank paper by Tito Cordella, has been criticised on two grounds: (a) that it prioritises private finance over public provision even for projects that may be profitable when undertaken with public funds, and (b) that it assumes the private sector is more efficient at development projects, notwithstanding the negative experience with PPPs.[27] But the Cascade approach doesn't just express an ideological preference for markets; more fundamentally, it seeks to lock in a particular type of financial system, that of financial capitalism organised around securities and derivative markets.

For the Cascade approach to achieve the MFD purpose of attracting (foreign) institutional investors, its sequence of Reforms, Subsidies and Guarantees will lead to the establishment of the legal, regulatory and institutional infrastructure for financial capitalism. This is the reason why market liquidity is among the core G20 "Principles of MDBs' strategy for crowding-in Private Sector Finance". The Cascade approach provides the blueprint for accelerating the transition to financial capitalism, with a set of steps that aim to ensure the following:

- the regulatory regime accommodates the creation of new asset classes (including tradable PPPs), by for instance preferential capital weights or regulatory loopholes.
- banks can engage in securities and derivative market-making activities with little or no regulatory restrictions, particularly on their provision of services and market infrastructure for foreign investors.
- securities can leave temporarily the portfolios of patient investors. This can be done, for instance, by encouraging securities lending.
- securities can be financed in repo markets and hedged via derivative markets. This requires a specific legal framework where the repo lender can acquire legal ownership of collateral, where the market-value of securities can be calculated on a daily basis to accommodate exposure to daily changes in the price of securities, and where securities can be re-used repeatedly in new lending arrangements (a practice also known as rehypothecation).

- there is full regulatory freedom for financial institutions engaged in financial engineering of complex structured products to create tradable assets out of PPP project portfolios.
- deregulation of capital flows into development projects and programs.

In this transition, the space for alternative development strategies shrinks further. Public resources have to be dedicated to: (a) de-risking 'developmental' assets, (b) identifying 'bankable' developmental projects that can easily be transformed into tradable assets, and (c) mopping up the costs of the financial crises intrinsic to this more fragile model. Meanwhile, the state will increasingly dismantle the financial infrastructure that can support a developmental agenda (including developmental banking, state-owned banks).

It is tempting to think that MFD will eventually generate positive externalities, by creating the capital market infrastructure that will improve financing conditions for SMEs in low income countries, and thus trigger the much needed structural change. Historical experience suggests otherwise. Since 2010, Germany attempted to engineer a bond market for SMEs from Mittlestand, the area famous for its highly successful SME sector. Mandatory volumes for issuance were reduced to EUR 10 million to allow SMEs to tap capital markets. By 2017, the experiment turned into a disaster. A third of issuers were unable to repay the interest or the principal on their SME bonds. Research found that SMEs' interest expenditures increased significantly with the issuance of bonds, and that companies' overall operating performance deteriorated significantly. This is consistent with the intuition that financialised capitalism can easily cannibalise the profits of the productive sector.

FAQ9. HOW DOES THE WORLD BANK GROUP FURTHER FINANCIALISE DEVELOPMENT?

The WBG has received advice from various sources for the MFD agenda. In a March 2018 interim report, the G20 Eminent Persons Group outlined six proposals to strengthen the coordination of the various IFIs for a greater development impact (see Alexander 2018 for a detailed account). The six proposals for system-wide collaborations promote the financialisation of development interventions as follows.

The proposals call for:

- International Financial Institutions (IFIs) to collaborate through locally owned country platforms to develop the supply of bankable projects and share knowledge/data. Data sharing would further support infrastructure data platforms that are critical for the process of securitising MDB loans.
- IFIs to develop system-wide risk insurance that increases the number of bankable projects that are currently impeded by high political risk premiums. This involves system wide risk guarantees, standardised and pooled to re-insurers in such a way that it generates cash flows amenable to securitisation, in part financed by sovereigns. Put differently, this calls for fiscal resources to be re-directed to guarantees against political risk.
- securitisation of loans across the MDBs system, through the tranching process described above to create tradable assets with different credit ratings that can be moved to investors with different risk appetites. It advises MDBs to retain a stake in the junior tranche (via, say an SPV, as discussed below) in order to incentivise the private sector, and to consider securitising both private and sovereign loans. While MDBs would follow the post-global financial crisis advice for issuers to retain skin in the game (by retaining

some portion of the securitised tranches on their balance sheets), the power relationships at play are different when MDBs securitise loans as opposed to private banks doing so. As originators, MDBs may be tempted to rely on political pressures on low and middle income countries to provide a wide range of guarantees and de-risking instruments, including protection against demand risk in securitised PPP-type infrastructure projects.

The G20 Eminent Persons Group recognises that its proposals to actively re-engineer DECs financial systems and insert them into the global supply of securities entails significant systemic risks. It suggests a three-pillar strategy for these plans to secure the benefits of open financial markets by mitigating their systemic vulnerabilities. It calls on the IMF to: (a) lead the development and management of a framework for managing volatile capital flows such as the portfolio flows into infrastructure-backed securities; (b) foster a resilient global safety net that can mobilise resources effectively to address a wide range of global financial fragilities, however difficult the implied changes in the global governance framework may be; and (c) integrate financial surveillance and a well-functioning early warning system.

Yet the Eminent Persons Group's paper does not make the MDB shift towards securitisation conditional on the three-pillar strategy. Its concerns with financial instability could become an empty, virtue signaling gesture insofar as the first two pillars are clearly unrealistic options. The IMF is a reluctant supporter of capital flow management, despite paying lip service to the importance of the global financial cycle, and the extent to which this curtails domestic control over financing conditions. Indeed, the IMF has embraced the positions that freely floating exchange rates can function as a buffer for capital flow volatility and that capital controls should be a measure of last resort after countries have implemented monetary and fiscal austerity. The IMF is yet to produce a credible taxonomy of capital controls for middle and low-income countries or to advise such capital controls even for countries confronted with capital outflows (as for instance in Argentina). The second, 'clean after the crisis' pillar is vulnerable to the political cycles of countries at the core of global finance, particularly the issuer of the global reserve currency, the US dollar. It is highly doubtful that the Trump Administration would view a resilient global safety net as a crisis priority, as the Obama administration implicitly did when it allowed the US Federal Reserve to create unprecedented swap lines that provided US dollar financing to other large central banks.

The Center for Global Development (CGD) has provided input to the G20 Eminent Persons Group, including "More mobilising, less lending", a document which proposes an MDB shadow bank, but is silent on the potential financial stability issues raised by MFD (see Lee 2018[28]). Specifically, it proposes upgrading the MDB private sector windows (PWS) with a special purpose vehicle (SPV), thus shifting to a new financial model that "facilitates more risk tolerance, increased mobilisation of private finance and greater development impact". The SPV arm of the PWS for each MDB would be guided by two priorities that would expand the range of bankable projects by supporting:

- the securitisation of infrastructure and other development-related loans by taking the junior or equity tranche, and moving the senior tranches to global investors, and
- the development of local securities markets.

For these efforts to be effective, the CDG calls on MDBs to use their sovereign lending in order to promote 'well–targeted policy and institutional reforms that makes projects financially viable and helps to finance the public share of public-private partnerships' (p. 3). This is a veiled call for conditionality and/or MDB political pressure on low and middle-income countries to put their fiscal resources at the service of the de-risking architecture envisaged by the MFD approach (as for example guarantees/subsidies for demand risk or political risk).

The CGD proposes that the MDB shadow bank play a critical role in promoting financialised ecosystems in low and middle-income countries. The SPV would be an opportunity to "strengthen a culture of openness to innovation and push out the risk tolerance frontier within the PSW as a whole" (p. 4). This is the type of celebratory rhetoric that would make it more difficult for countries to manage the systemic vulnerabilities arising from the MFD push for reengineering financial systems around securities, repo and derivative markets.

Another detail worth considering in the CDG proposal is the organisation of the SPV. One variant could be a single SPV for the entire MDB world, managed by the World Bank given its global mandate, with a global portfolio that would thus multiply the securitisable loans. Another possibility is a private-public SPV, where the MDBs would enter into partnership with 'risk-tolerant impact investors and philanthropists' who would also contribute with "innovations and efficiency gains". This last scenario is particularly problematic in that it envisages high risk, high leverage financialised investors (with appetite for the junior tranches) as legitimate and entirely beneficial actors in international development. In the process, it paradoxically exposes the MDBs, as a group, to the vulnerabilities of the high leverage model.

FAQ10. WHAT ARE THE NEW MECHANISMS THAT WOULD GREATLY EXPAND THE POWER OF MDBS TO SERVE WALL STREET?

The MFD and its Cascade approach re-imagine MDBs as active agents in the process of re-engineering DEC financial systems to better connect them to financialised globalisation.

- MDBs will be able to influence, if not altogether shape, the terms on which DECs join the global supply of securities. These will likely reflect the preferences of global banks and global institutional investors.
- MDBs will shape the definition of a 'bankable' project. It is likely that this will prioritise large infrastructure projects at the expense of smaller projects with more developmental potential.
- MDBs plan to pioneer the securitisation infrastructures that will transform bankable projects into tradable securities. This will generate significant revenues for globally systemic financial institutions, and further cement their dominant positions in financial globalisation.
- MDBs will be closely involved with designing the 'de-risking'/subsidies measures and persuading DEC governments to finance the associated costs, in their roles as guarantors of private financial profits.
- MDBs may push for DEC pension systems to converge on the US model of private pensions in order to create local institutional investors. The tendency to foster concentration in the asset management sector (to exploit economies of scale and scope) may result in US-based asset managers absorbing the funds of DEC institutional investors, and making allocation decisions on a global level.

FAQ11. WHAT ARE EXAMPLES OF LEVERAGE POINTS FOR PROMOTING ALTERNATIVES TO THE WORLD BANK GROUP'S MFD STRATEGY?

• We don't want your money, we want ours

A non-negligible proportion of the money flowing into the Global North shadow banking sector (institutional investors, asset managers) originates in the Global South but does not stay there because of tax arbitrage and tax avoidance by multinational corporations and high-net worth individuals. Fighting for tax justice would increase the resources directly and discretionarily available to governments in the Global South.

• Fiscal resources for private finance: establish a framework for accountability and transparency for 'de-risking' commitments and subsidies

The MFD agenda is ambitious. It explicitly pursues systemic change, from regulatory regimes to re-engineering systemic financial market architectures and re-ordering the state as guarantor of private financial profits in development projects. This reduces state resources directly available for developmental projects.

If the MFD's Cascade approach commits fiscal resources to 'de-risking' local securities and financial instruments in order to attract foreign (institutional) investors, it is important that the MDBs develop an analytical framework that sets out clearly the costs of de-risking and subsidies over the life of the projects. This framework should allow civil society organisations and other public interest actors to closely monitor costs in order to ensure the transparency and accountability of the 'de-risking' framework.

• The negative macro-financial effects of foreign investors presence may outweigh the positive developmental impact

The MFD agenda puts foreign investors and portfolio flows at its core. It should spell out clearly how DECs will (a) manage the systemic vulnerabilities of being more closely integrated in globalised finance and, more importantly, (b) use various policy tools (e.g., capital controls and macroprudential measures) to ensure the central bank's independence from the global financial cycle in order to better control domestic credit conditions.

Although IFIs recognise that portfolio flows are pro-cyclical, they only recommend capital controls once countries have tightened monetary and fiscal policies. There is an inherently contractionary bias in the new IMF position on capital controls that insists on higher interest rates and tighter fiscal policies. In practice, there is compelling evidence that monetary and fiscal policies cannot address the systemic fragilities of market-based finance; paradoxically, policies amplify them (higher interest rates attract further capital inflows).

• The MFD model shrinks developmental spaces

Developmental states have historically been successful where they followed closely the logic "politicians reign, technocrats rule, businesses comply". State goals cannot be directly reduced to and equated with private interests, when development strategies focused on productivity growth and industrial upgrading require highly-capable, development-oriented bureaucracies. Technocrats introduce market-distorting interventions to protect strategic industries, identified according to criteria related to high-income elasticity of demand in world markets, potential for rapid technological progress and labour productivity growth. Traditional banks play a critical role, providing subsidised finance to strategic sectors. The developmental state and its banks enforce performance criteria and market-based incentives in order to avoid "white elephant" projects.

The traditional developmental model needs upgrading. For instance, development priorities geared towards industrial upgrading need to be better aligned with environmental and social concerns. However, it is unclear whether this rethink is possible in a world where financial systems are increasingly organised around securities markets and connected on the balance sheets of global institutional investors. There are structural and political reasons to be doubtful.

Structurally, financial systems organised around securities markets change the incentives and business models in banking. Banks tend to re-orient their activity towards securities and derivative markets where opportunities for short-term profits are significantly higher than the development of costly, information intensive long-term relationships.

Politically, development-oriented bureaucracies have to include technocrats familiar with the complex ecosystem of securities markets. These will have to coordinate with the central bank in order to agree on frameworks for regulating cross-border flows into securities markets, on the one hand, and managing the systemic fragilities, on the other.

ENDNOTES

[1] See Rey, H. (2015). *Dilemma not trilemma: the global financial cycle and monetary policy independence* (No. w21162). National Bureau of Economic Research.

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[3] See Hager. B.S. (2016) The making of the modern 'Debt State'. http://speri.dept.shef.ac.uk/2016/03/10/the-making-of-the-modern-debt-state/

[4] The European Commission launched its Sustainable Finance project in 2018. It aims to re-orient investments towards more sustainable technologies and businesses, to finance growth in a sustainable manner over the long-term and to contribute to the creation of a low-carbon, climate resilient and circular economy. See https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en

[5] See Haldane, A. (2009) Rethinking the financial network. Available here https://www.bis.org/review/r090505e.pdf

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[11] See Balluck, K. (2015) Investment banking: linkages to the real economy and the financial system. Available at https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2015/investment-banking-linkages-to-the-real-economy-and-the-financial-system.pdf?la=en&hash=9CF8F38964AE994D664A57351C5A0E472BBF2876

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[13] Naqvi, N., Henow, A., & Chang, H. J. (2018). Kicking away the financial ladder? German development banking under economic globalisation. *Review of International Political Economy,* 1-27.

[14] Holton, S., McCann, F. (2017), "Sources of the small firm financing premium: evidence from euro area banks", Working Paper Series, No 2092, ECB, August.

[15] https://www.imf.org/en/News/Articles/2018/05/07/sp050818-challenges-for-monetary-policy-from-global-financial-cycles

[16] https://www.livemint.com/Opinion/ujv4n786ndQjcA8MfpwNTJ/Every-thing-you-want-to-know-about-Indian-bond-market-but-we.html

[17] In a 2015 speech, Mark Carney, the governor of the Bank of England and the head of the Financial Stability Board, warned that: "A number of market participants may over-estimate the liquidity of [long-dated] securities. An example is the big increase in daily liquidity asset managers in emerging market corporate debt. That is a very illiquid market at best of times, and extremely illiquid when inevitably you have a turn in interest cycle in United States, and you get a sudden stop of capital flows to emerging markets and all of a sudden it is very difficult to get out of those positions".

[18] See Gabor, D. (2016), The impossible repo trinity. Cited above.

[19] See Gabor, D. (2018) Goodbye (Chinese) shadow banking, hello market-based finance. Development and Change, https://onlinelibrary.wiley.com/doi/abs/10.1111/dech.12387

[20] See Carney, M. (2017) What a difference a decade makes. Remarks at the Institute of International Finance's Washington Policy Summit, the Reagan Centre, Washington DC.

[21] See McCauley, R. and M. Scagtina (2011). Foreign exchange trading in emerging currencies: more financial, more offshore. Available https://www.bis.org/publ/qtrpdf/r_qt1103h.pdf

[22] See Gabor and Brooks (2017) cited above.

[23] See Gabor (2018) cited above.

[24] See Gabor, D., & Brooks, S. (2017). The digital revolution in financial inclusion: international development in the fintech era. New Political Economy, 22(4), 423-436.

[25] http://documents.worldbank.org/curated/en/937611523856702598/pdf/125276-BRI-PUBLIC-13-4-2018-14-34-37-MFDBriefKenyaInfrastructure.pdf

[26] ESG bonds are fixed income securities that are issued in accordance with a set of Environmental, Social and Governance criteria. While there is no generally agreed set of ESG criteria, the European Commission is working on identifying such a set in its Sustainable Finance program https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en

[27] See Carter, P(2018). https://www.cgdev.org/blog/world-bank%E2%80%99s-preference-private-finance-explained

[28] Lee, N. (2018) More mobilizing, less lending: a pragmatic proposal for MDBs'. https://www.cgdev.org/publication/more-mobilizing-less-lending-pragmatic-proposal-mdbs

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