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Abstract

The paper analyzes the relation between premature deindustrialization in Latin America with what is termed premature financialization. Premature financialization is defined as a turn to finance, organized as an industrial concern, which is a vehicle for accumulation before the process of industrialization has reached maturity. This contrasts with developed countries where financialization occurs after an advanced stage of economic and social development is reached, and where the growth of the financial sector, beyond a certain threshold, can be detrimental to economic activity. The paper examines the consequences of premature financialization for investment, growth, and financial stability.

Key Words: Deindustrialization, Financialization, Financial fragility, Latin America
JEL Codes: E44, G21, G23, O54

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1. Introduction

Financialization and deindustrialization have been discussed as interrelated concepts in the literature, which deals mostly with advanced economies. The rise of finance, measured in several different ways, seems to be related in part to the literature on industrial decline. Over the last three decades, the literature on deindustrialization in Latin America has expanded owing to the failure of the development strategy adopted after the 1980s debt crisis to promote productive diversification and faster rates of economic growth.² This process of deindustrialization has been dubbed premature, since it occurred not as the consequence of the maturity of the manufacturing sector – arguably the case in the United States and other advanced economies – but as a result of the inability to integrate into the manufacturing Global Value Chains (GVCs). This paper suggests that premature deindustrialization has gone hand in hand with premature financialization, which is defined as a turn to finance, organized like an industrial concern and used as a vehicle for accumulation before the process of industrialization has reached maturity.³ The danger is premature financialization might lead to an increase in financial fragility.

Financial fragility refers to a situation where growing indebtedness generates increasing debt payment commitments that will eventually exceed income cash flows. It is the result of the workings of an economy in which lending and borrowing take place based on a decrease in the size of the margins of safety. As the margins of safety decrease economic agents become more dependent on income flows for debt payments and the “normal functioning of financial markets to refinance positions in long-term assets” (Minsky, 1986: 209). As a result, any disruptions in income or in financial markets can lead economic agents to experience difficulties in paying their debt (debt service and or principal), leading to liquidity constraints and outright insolvency. The size and strength of margins of safety of the different sectors in an economy, as well as the likelihood that an initial disturbance is amplified, determines the robustness or fragility of an economy.

The rest of the paper is divided in three subsections. Section 2 discusses the concepts of financialization and premature financialization and provides a comparison between the United States and Latin America. Section 3 discusses the process of financialization in Latin America. Section 4 discusses the resulting increase of financial fragility.

² Fajnzylber (1983) provides one of the most perceptive and lucid analyses of the incomplete and failed industrialization of Latin America. The book was written as a response to the growing conviction that free market policies were the answer to Latin America’s development problems. The industrialization model prevailing between 1950 and 1970 was dysfunctional and the rise of neoliberalism was due in part to the irrationality of then prevailing model of industrialization. The key problems of the prevailing industrialization model included capital goods underrepresented in the industrial structure, imitative patterns of consumption, high dependence on natural resources and low wages; lack of industrial competitiveness. An important was that as he put it (Ibid.: 207): “contrarily to the fundamental role that the industrial sector has had in developed countries as a source of surplus in the external trade relationships, in Latin America it’s an explanatory factor of the structural character of the trade deficit and as result of the increasing external indebtedness.”

³ Abeles et. Al. (2018) refer to a similar concept, that of ‘peripheric financialization’ that is associated with the unrestricted liberalization of the financial account of the balance of payments.

2. Financialization and premature financialization

Financialization is often criticized as a fuzzy concept, defined ambiguously in a similar way to the notion of neoliberalism, a notion that is frequently related to the former (Duménil and Lévy, 2011).⁴ In heterodox economic circles, the definition most often cited is by Epstein (2005: 1) who argues that: “[f]inancialization refers to the increasing importance of financial markets, financial motives, financial institutions, and financial elites in the operation of the economy and its governing institutions, both at the national and international level.” This broad definition is also typical in other social sciences. In similar fashion, a widely cited study by a sociologist argues that financialization is “the growing weight of finance in the American economy” (Krippner, 2005: 174).⁵

This view suggests that the financial sector is hypertrophied, and that financial activities are somehow detrimental to the economy as a whole, at least beyond a certain threshold level. That is true both in heterodox views as well as in mainstream accounts of financialization.⁶ In other words, finance is seen as detrimental for investment and growth, the underlying assumption being that financial speculation crowds-out productive investment. A large empirical literature has emerged that seeks to identify the increase in the size and changing nature of financial markets which characterize financialization. The theoretical explanation is usually associated with the ascendancy of short-termism in corporate governance, related to shareholder values (Davis, 2017). As Palley (2007: 15) notes, in that conceptualization of financialization, the way in which the size and influence of finance increases with respect to the real productive sector depends upon the influence of financial sector interests on the operation of financial markets, on the behavior of nonfinancial corporations, and through financial interests’ ability to change economic policy, in particular regulation.

A second approach to conceptualizing financialization defines it as a stage in the development of capitalism (Sawyer, 2013-14). Many analysts, going back at least to Rudolf

⁴ For Duménil and Lévy (2011) financialization corresponds to the neoliberal phase of capitalism since the 1970s. The authors say: “[g]iven the role conferred on financial interests in contemporary capitalism, the term ‘financialization’ is also used in a broader sense in the literature, encompassing most of the features of neoliberalism. There is a lot of meaning in the assertion that neoliberalism is a ‘financialized capitalism,’ sometimes denoted on such grounds as ‘financial or finance capital(ism)’” (Ibid.: 35). See also Fine (2013) for a similar argument with roots in Marxian political economy views.

⁵ Krippner (2011: 22) argues that “the turn to finance was an unintended consequence of policymakers’ attempts to extricate themselves from the problems they confronted in the guise of social crisis, fiscal crisis, and the legitimation crisis of the state.” The position taken in this work is diametrically opposed in that respect, suggesting that the rise of finance was a policy decision, not the unintended consequence of limitations imposed on the state. In that sense, this work puts more emphasis on the decisions to liberalize and deregulate financial markets, that reflected the changing political tides, and the ascendancy of financial interests.

⁶ While it is true, as noted by Fasianos et al. (2018: 36), that within mainstream economics finance is seen in general as positive for growth, it seems clear that, at least since the Global Financial Crisis of 2008 some mainstream authors have acknowledged that finance might be overgrown, and that the instability associated with financial deregulation might be harmful for the functioning of the system. In that respect see Arcand et al. (2015), that acknowledge the work of some heterodox authors, like Arestis and Demetriades (1997), showing that neither causality between finance and growth, nor a particular type of system, be that a bank-based or a market based financial sector, can be determined to be universally more efficient.

Hilferding, see the financial stage as a late phase of the development of the system, and often related to a decline of the industrial power, the difficulties of absorbing the surplus, and, arguably, related to deindustrialization.⁷ In this view, the decline of hegemonic power, for example in the case of the United Kingdom after the First World War, is associated with significant inertia and persistent influence of finance. In the same vein, the decline of American dominance and the rise of China are seen in this literature as being directly associated with the rise of financial interests. In Jagdish Bhagwati's apt expression, those interests are labelled the Wall-Street-Treasury complex which substituted for Eisenhower's Military-Industrial complex. In that light, industrial decline and financialization are part of a broader cycle of the rise and fall of hegemonic powers, which is related to the broad historical cycles of capitalism (Arrighi, 1994).

For one group financialization is essentially the current phase of capitalism, associated with the ascendancy of the market-friendly policies of the Washington Consensus, in particular to financial liberalization.⁸ As noted by Lapavistas (2013) this broader conception can be associated with heterodox traditions, in particular the *Monthly Review* group and French regulationists, which have broad affinities with Marxism. The other approach that emphasizes the empirical characteristics of financialization can be associated with Post Keynesian groups.⁹ However, though the two approaches seem to diverge in the relative importance of structural and more conjectural or cyclical understanding of financialization, there is no inherent contradiction between the two.

In some of the analyses financialization is equated with the growing importance of the rentier class and speculators which probably has its origins in the way Keynes treated the financial sector in his *General Theory*. In this paper, we argue that financialization goes beyond these views and that financial activity is organized under the functioning logic of an industry, and that the relations between finance and manufacturing are not always antagonistic, as for example discussed in Sraffa (1922: 196).¹⁰ Rentiers and speculators are the result rather than the cause of financialization.

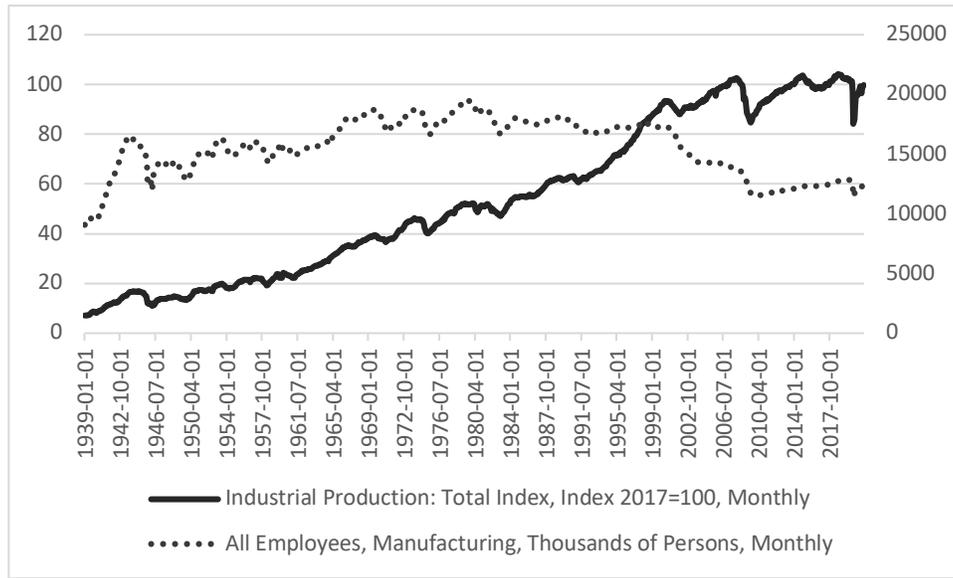
⁷ The role of finance was central in the Marxist literature on imperialism, including the work of Lenin. As Bottomore (1991: 199) notes banks had a new role. He argues that “[a]s banking develops and becomes concentrated in a small number of establishments the banks grow from modest middlemen into powerful monopolies having at their command almost the whole of the money capital of all the capitalists and small businessmen and also the larger part of the means of production and sources of raw materials in any one country and in a number of countries.” Hilferding and Lenin identified three ways through which banks control industry: the rise of the joint stock company, the presence of bank directors in the board of firms and vice versa and the detailed information of firms' financial operations and financial situations that banks obtain through the handling of their financial transactions.

⁸ Sawyer (2013-14: 7) argues that “there are periods of definancialization as well as those of financialization.” The same argument, with a periodization for these ups and downs of financialization, has been recently proposed Fasianos et al. (2018). This interpretation implies that financialization is not necessarily a fundamentally new phenomenon and is not restricted to the current phase of the development of the capitalist system.

⁹ On Post Keynesian views see Palley (2007) and Hein and van Treeck (2008)..

¹⁰ See Panico and Pinto (2017).

Figure 1: Deindustrialization in the US (1939-2021)



Source: FRED

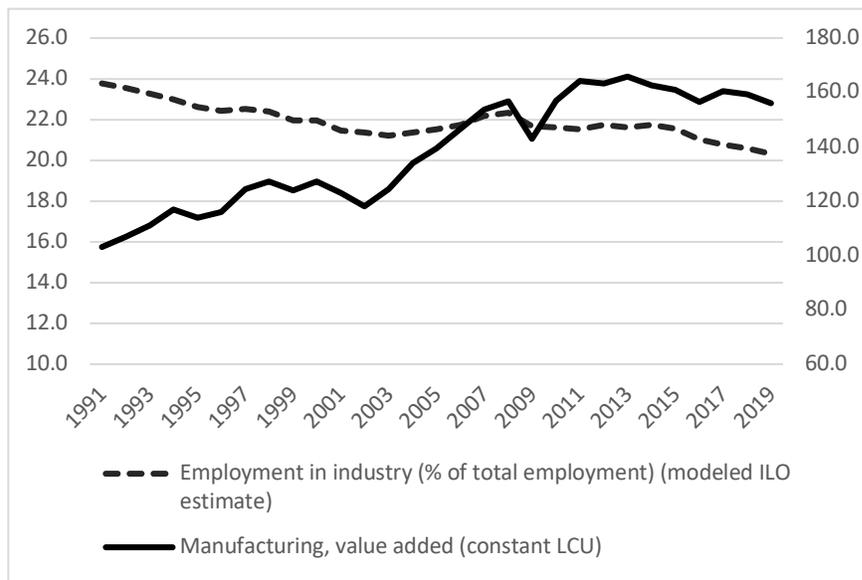
The notion that financialization, measured in a variety of ways, is somehow connected to the decline of the productive capacity of the economy is more problematic. Deindustrialization in the United States is associated with the reorganization of global manufacturing which has been driven by the demise of the Fordist paradigm and the rise of flexible production methods, combined with the movement of the center of gravity of global production to East Asia, in particular to China over the last twenty years. It has also been related to a new development strategy in Latin America. One part of that strategy is “reprimarization” of production in South America, while the other part is “maquilization” which reduces the domestic value added in manufacturing production in Central America and Mexico (Pérez Caldentey and Vernengo, 2010). In the case of the United States, while growth of industrial output has plateaued since the Global Financial Crisis, there has not been an outright decline. Instead, the deindustrialization process has involved decline of employment in manufacturing activities, with consequent political implications (Figure 1).¹¹

Something similar is also visible in Latin America (Figure 2), where manufacturing output – measured as the average of the manufacturing value added in local currency units (LCU) in the three largest economies (Argentina, Brazil, and Mexico) – seems to have stagnated in the 2000s.

¹¹ In fact, according to UNCTAD (2018: vi) American corporations remain dominant in key sectors, for example in the digital field. In the same vein, The Economist (2021: 11) has recently argued “only America and China have been able to marshal the process of creative destruction. Of the 19 firms created in the past 25 years that are now worth over \$100bn, nine are in America and eight in China. Europe has none. Even as mature tech giants like Apple and Alibaba try to entrench their dominance, a new set of tech firms including Snap, PayPal, Meituan and Pinduoduo are reaching critical mass. The pandemic has seen a burst of energy in America and China and a boom in fundraising. Firms from the two countries dominate the frontier of new technologies such as fintech and electric cars.” This suggests that a more symbiotic relationship between the United States and China developed as a result of the opening of relations in the 1970s – called Chimerica by Niall Ferguson – and before the more contentious rivalry associated to the so-called trade wars arose in the last few years. On the trade wars between the US and China see Hanson (2021).

It grew more in Mexico and in Argentina during the recovery after the 2002 default but remained flat in Brazil. Those developments in Latin America went hand in hand with relatively stable levels of employment in the manufacturing sector as a share of total employment, with the exception of a major decline in the 1990s in Argentina. That suggests labor productivity has not increased in Latin America, unlike the United States.

Figure 2: Premature deindustrialization in Latin America (1991-2019)



Source: World Bank Indicators

If there is a connection between the role of financialization and deindustrialization, for the United States that suggests the effect has not been associated with a decline of the competitiveness of its national corporations.¹² In other words, it is possible that the new phase of capitalism is not necessarily associated with a decline of industrial power and decline of hegemonic power.¹³ On the other hand, premature deindustrialization seems to be more clearly associated with decline of the industrial sector in the periphery, and inability of national firms in the periphery to insert

¹² Since at least the 2000s developed countries, and, in particular, the United States have experienced production shifts consisting with the reallocation of production from the United States to developing countries including China. These are not specific to any particular industry or product line but rather occur across a wide spectrum of industries and products (Bronfenbrenner and Luce, 2004). A significant piece of evidence that illustrates the importance of the restructuring of production is that it involves well-established multinational corporations mostly in the manufacturing sector. This implies that although the manufacturing sector may have declined within the United States this may not have the case when considering the manufacturing in terms of nationality rather than residence.

¹³ The decline of American hegemony is a common topic in part of the literature associated with financialization. Panitch and Gindin (2013) argue that financialization, as one of the characteristics of the more recent globalization process, is firmly established under the new American imperialism. In their words, “by the millennium all the elements of ‘globalization’—the transformations in the global division of labor, the development of competitive networks of production, and a new financial architecture to facilitate accelerated financialization—were implicated both in the US economy’s continuing centrality in global capitalism and in the successful integration into it of the huge and fast-growing Chinese economy” (Ibid.: 18-19).

themselves in GVCs. That corresponds to the Latin American experience (Rodrik, 2016; Palma, 2019).

In that light, the main effect in Latin America of financialization, understood as a new phase of development of capitalism, has been reorganization of production and its connection to the global economy. However, that provides only a partial understanding of the effects of financialization in the region.¹⁴ Over the last four decades, it has also become relatively clear that there is a global financial cycle in which developing economies are subordinated (Medeiros, 2008; Borio, 2012). The greater integration of Latin America during the so-called “first globalization”, or the period of the primary export model, required stable financial flows from the center to promote the infrastructure necessary for the functioning of the system. In contrast, the new globalization phase has come with an increase in the size and volatility of capital flows. The renewal of capital flows in the 1970s, and the process of deregulation and liberalization, ended abruptly with the Mexican Debt Crisis, in 1982. Thereafter, there was a renewal of flows in the 1990s after the Brady Plan, but it came with a return of bond finance instead of bank loans, plus elimination of capital controls. Those changes were sponsored by the International Monetary Fund (IMF) and supported by the US government. Following the 2008 Global Financial Crisis, the bond market has become the major source of liquidity for Latin America and the Caribbean (BIS, 2021a; Shin, 2013).

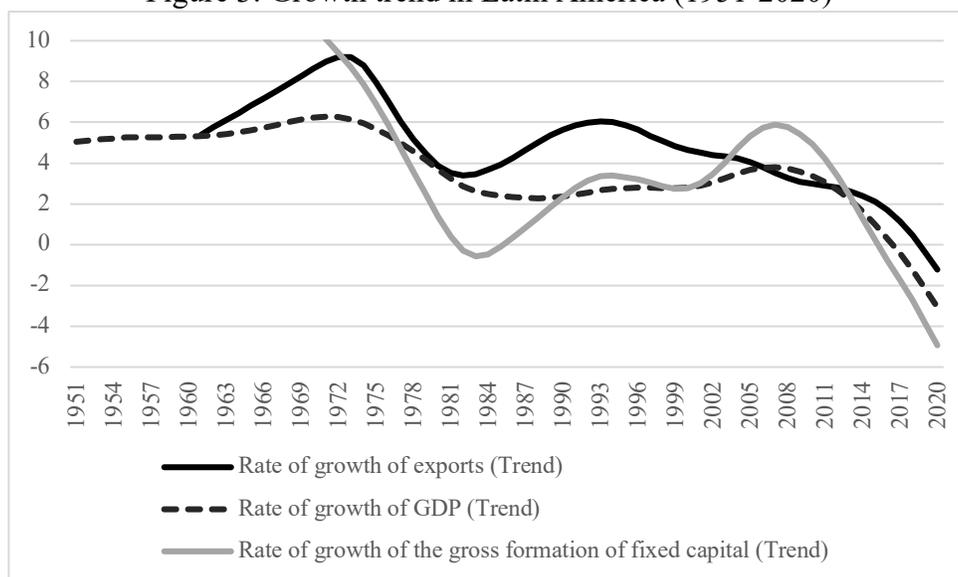
Premature deindustrialization can be seen as the result of a process of change in the structure of production before a higher stage of development (i.e. a higher income per capita and a turn to services) has been achieved, with detrimental consequences for growth. In parallel fashion, the hasty opening of the capital account and deregulation of financial markets in the region might be termed premature financialization. By this we mean local elites decided to adopt a model of development that required greater financial integration to the global economy and promoted explicitly the process of financial liberalization. That led to financial instability and was also detrimental for economic growth. This obviously hurt industrial interests in the region, but there is a danger of exaggerating the dichotomy between financial and industrial interests, which are more integrated than is often understood. That is because commodities have become more financialized, and nonfinancial corporations have also increasingly come to play an important role in the process of expansion of the scope of financial activities. Consequently, premature financialization is not part of a more advanced stage of development of capitalism in Latin America but is part of a strategy of development which has insidious effects in the region. It promotes and is symbiotic with a strategy of development that leads to relatively low dynamism of exports, reliance on commodities, and reliance on capital inflows, including remittances. All of that has exacerbated the historical problems in the region with the external constraint and has also made the region particularly vulnerable to financial crises.

¹⁴ The argument here parallels the position taken in Abeles et al. (2018: 20), who argue against the risk of assuming that financialization is purely a macroeconomic phenomenon detached from the productive economy.

3. Financialization in Latin America

The economic performance of Latin America and the Caribbean is characterized by a sharp dichotomy between the performance of real sector indicators and those of the financial sector. Latin America and the Caribbean have traditionally exhibited a decline in its trend growth rates of GDP, investment, and exports. There has also been a continuous decline in labor productivity growth. This is illustrated in Figure 3 which shows the evolution of trend growth for GDP, investment, and exports for the period 1951 to 2020. For its part the rate of growth of labor productivity declined from 1.87 to -0.015% between 1970-1979 and 2010-2019.¹⁵

Figure 3: Growth trend in Latin America (1951-2020)



Note: Trend using Hodrick-Prescott filter (expressed in constant 2010 US\$)

Source: On the basis of World Bank Development Indicators (2021)

In contrast with the poor economic growth of real activity, which has trended over time towards virtual stagnation, the financial sector has witnessed significant growth in terms of volume, participants, instruments and products. That is the result of the general process of commercial and financial liberalization, privatization across a wide number of areas and activities, and concentration of productive and financial ownership that has underpinned Latin America's economic strategy since the 1990s.

¹⁵ According to Paus (2019) the rate of growth of labor productivity in Latin America has lagged over the past thirty years behind that of all other developing regions. Also, the ratio of labor productivity of Latin America to that of the United States fell from, roughly, 30% in the 1980s to 20% in the 2000's.

Table 1: Rate of return on equity (ROE) of commercial banks and bank concentration (%)

	Rate of Return on Equity		
	1996-2000	2001-2009	2010-2017
East Asia & Pacific	7.6	14.2	12.7
Europe & Central Asia	14.9	11.7	4.9
Latin America & Caribbean	13.5	15.9	12.9
Middle East & North Africa	19.4	13.9	12.3
North America	11.5	11.9	10.4
South Asia	19.1	16.2	14.8
Sub-Saharan Africa	23.7	23.5	17.5
Median	14.9	14.2	12.7
Median	3.5	3.9	3.5
	Bank Concentration		
	1996-2000	2001-2009	2010-2017
East Asia & Pacific	65.6	71.7	62.3
Europe & Central Asia	74.4	70.7	65.5
Latin America & Caribbean	63.8	68.6	70.3
Middle East & North Africa	71.0	72.4	71.3
North America	32.8	60.1	63.9
South Asia	65.8	60.6	52.4
Sub-Saharan Africa	84.9	79.8	72.0
Median	65.8	70.7	65.5

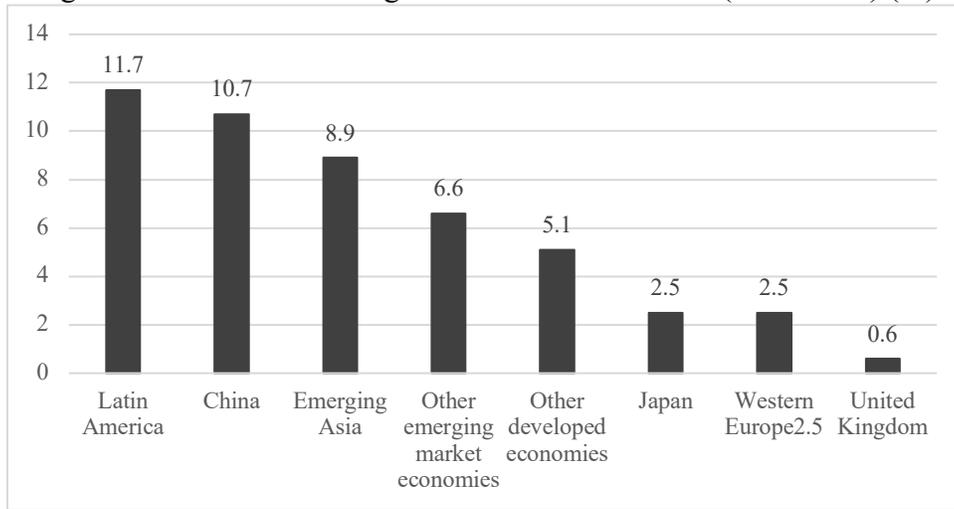
Note: Bank concentrations refers to the assets of three largest banks as a share of assets of all commercial banks.

Source: Beck, Demirgüç-Kunt and Levine (2000, 2009, 2012, 2019).

The financial sector's performance has been underpinned by high levels of profitability. Data available from 1996 to 2017 show that profitability for Latin America and the Caribbean, whether measured by the rate of return on assets (ROA) or the rate of return on equity (ROE), increased from the middle of the 1990s until the 2008 Global Financial Crisis. That increase allowed the profitability of Latin American commercial banks to exceed the world average. Even though profitability declined after the Global Financial Crisis, the performance of Latin American and Caribbean banks remained, on average, above the world average. Additionally, during the period 2010-2017, the profitability of commercial banks in Latin America and the Caribbean exceeded all other regions in the world except South Asia and Sub Sahara (Table 1).

A more recent study shows that between 2012 and 2017, the Latin American banking industry was the fastest-growing banking market worldwide (Baquerizo, et al., 2019). During this period, banking revenue before cost of risk grew at a compound annual growth rate of 11.7% surpassing all the different regions in the world and exceeding the world average by roughly six percentage points (Figure 4).

Figure 4: Growth of banking revenue before risk cost (2012-2017) (%)



Source: Baquerizo et al. (2019)

Bank profitability (ROE) is explained by the rate of return on assets (ROA) rather than by leverage (L) (ROE can be expressed as the product of the rate of return on assets and leverage, that is (1) $ROE = ROA * L$) (see Figure 5).¹⁶ This contrasts with the financing model of developed country commercial banks for which leverage (L) is a main explanatory variable of profitability (ROE).¹⁷ In turn the behavior of (ROA) is determined by the net interest margin, non-interest income and security gains and losses (for a given provision for loan losses and taxes paid).¹⁸ A rough estimate shows that the net interest margin represents roughly 35 to 40 percent of ROA.¹⁹

¹⁶ This can be derived as follows.

$$Bank\ Earnings \equiv Bank\ Earnings$$

$$\Leftrightarrow Bank\ Earnings \equiv Bank\ Earnings * \frac{Assets}{Assets} \Leftrightarrow \frac{Bank\ Earnings}{Equity} * Equity \equiv Bank\ Earnings * \frac{Assets}{Assets}$$

$$\Leftrightarrow \frac{Bank\ Earnings}{Equity} \equiv \frac{Bank\ Earnings}{Equity} * \frac{Assets}{Assets} \Leftrightarrow \frac{Bank\ Earnings}{Equity} \equiv \frac{Bank\ Earnings}{Assets} * \frac{Assets}{Equity} \Leftrightarrow ROE \equiv ROA * L$$

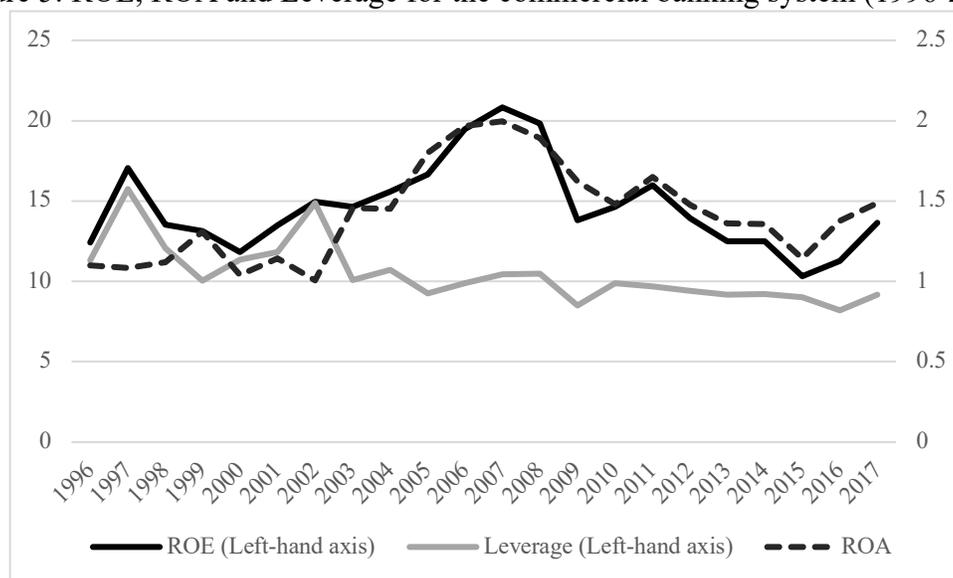
Where $\frac{Bank\ Earnings}{Assets} = ROA$ and $\frac{Assets}{Equity} = Leverage\ (L)$

¹⁷ Note in Figure 5 that L barely increased before the Global Financial Crisis and its level was much smaller than for developed countries commercial banks. Barajas et al. (2010: 26) reports a value of leverage of 16 in the last quarter of 2006 and 2007 increasing to 18.1 in the last quarter of 2008 for the ten largest banks in the United States.

¹⁸ (2) $ROA = \left(\frac{NIM}{A} + \frac{NII}{A} + \frac{SG}{A} + \frac{NIE}{A} + \frac{PLL}{A} + \frac{TAX}{A} \right)$ where net interest margin (NIM), non-interest income (NII), and security gains/losses (SG), non-interest expense (NIE), provision for loan losses (PLL), and taxes paid (TAX), divided by total assets (A). Barajas et al. (2010: 9).

¹⁹ In the case of the ten largest banks in the United States the net interest margin as a percentage of assets remained basically constant between the last quarter of 2006 and 2008 (Ibid.: 26).

Figure 5: ROE, ROA and Leverage for the commercial banking system (1996-2017)



Source: Beck, Demirgüç-Kunt and Levine (2000). Latest version September 2019.

Another important determinant of bank profitability is concentration. Latin American and the Caribbean is the only region in the developing world that increased its levels of concentration between 1996 and 2017. The assets of three largest banks as a share of assets of all commercial banks increased from an average of 63.8% to 70.3% between 1996-2000 to 2010-2017 (Table 1 above). An econometric exercise for the period 1990-2017 for a sample of Latin American and Caribbean banks estimated profitability (ROE) as a function of bank concentration (the total assets of the largest 20% of banks by total bank assets by country), the market share, bank size, and capital to asset ratio. It shows the concentration index to be statistically significant, with substantial effects when considering the larger banks (more than US\$ 10 billion in assets). A one percentage point increase in concentration produces an increase of 0.46 percentage points and 0.27 percentage points in the rate of return for the banks in which the greatest volume of assets is concentrated (eighth decile or more in terms of size).²⁰

Bank concentration has been accompanied by a growing presence of foreign banks in the region. Foreign banks account for a large share of the assets of the commercial banking system. They own more than 50% of total bank assets in the cases El Salvador (100%), Uruguay (92%), Mexico (70%), Honduras (53%), Paraguay (51%), Peru (51%), and between 25% and 33% of total assets for Costa Rica (26%), Guatemala (30%) and Chile (33%). That makes the banking system highly vulnerable to changes in the global financial cycle.

Not only has the financial sector become more concentrated, it has also acquired growing importance in the economy in terms of power and control over both the real sector and activities

²⁰ The market share was proxied by the net income as a percentage of total income. The estimation was based on the Generalized Method of Moments (GMM). The estimate was based on the specification found in Tragenna (2009.) See, ECLAC (2018).

that are unrelated to intermediation. Over time, the financial sector has diversified to include activities such insurance, capital markets and pension funds. In some countries, banks, and particularly the most important banks, operate as a part of larger financial conglomerates. A financial conglomerate is defined as “any group of companies under common control or dominant influence, including any financial holding company, which conducts material financial activities in at least two of the regulated banking areas, securities, insurance (or pensions)” (BIS, 2012). Note that a financial conglomerate, besides conducting activities in securities, insurance or pensions, can also be involved in activities within the real sector. Financial conglomerates participate in a range of diverse activities including agriculture, commerce, energy, manufacturing, mining, retail, and telecommunications.²¹

4. Financial instability in Latin America

Since the Global Financial Crisis, the decline in the trend rate of growth of GDP, investment, and productivity, and the solidification of the importance of the financial sector has been accompanied by growing levels of total indebtedness (domestic and foreign currency denominated debt). Available data for the general government shows that its total debt-to-GDP ratio remained roughly constant between constant at 46% between 2000 and 2008. However, after 2010, it shot up to reach 68% in 2019 and 79% in 2020 reflecting the effects of the Pandemic. The expansion in debt levels affects both the government sector and all the different sectors of the economy, particularly nonfinancial corporations. An analysis of a sample of 13 Latin American and Caribbean economies shows that between 2008 and the first quarter of 2020, nonfinancial corporate debt expanded by roughly 10 percentage points of GDP (24.0% and 33.4% of GDP respectively).²²

²¹ Chile which is one of the most financially open and liberalized economies in Latin America and the Caribbean exemplifies this trend. In Chile, the existence of financial conglomerates has important implications for the way banks operate in practice. By law banks are not allowed to engage in activities that are not directly related to financial intermediation (LGB, Art. 69). However, due to the fact that by far the majority of banks belong to financial conglomerates and operate as part of these the limitations on bank activities are of a more formal nature. As put by the OECD: “Banks...operate as part of larger conglomerates, where the bank itself is controlled by a holding company, which also controls a host of other group companies, which may include securities, firms, insurance companies and/or fund and pension managers. The bank itself can, however, own a brokerage company, which in turn cross-sells the products of the other group companies. In many cases it appears that that the separation of the various activities is more of a formal than a functional nature” (OECD, 2011: 21).

²² The countries in the sample include, Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Nicaragua, Peru, Dominican republic, Ecuador, El Salvador, Jamaica and Trinidad and Tobago. See, Talercio (2021).

Table 2: Outstanding amounts of debt securities (1990-2021) (US\$ Million)

Sector	1990	1995	2000	2010	2020	2021
All issuers	61,000	195,361	305,945	402,310	905,175	914,256
General government	53,794	146,682	225,035	230,796	452,553	463,998
Nonfinancial corporations	3,506	25,763	53,563	103,256	336,241	332,220
Financial corporations	3,560	22,916	27,347	68,258	116,380	118,038
Private banks	1,900	14,467	12,369	35,880	52,749	52,432
Private other financial institutions	74	1,827	5,833	25,003	41,779	44,115
Public other financial institutions	347	1,809	1,150	723	13,557	13,551
Public banks	265	2,901	6,570	6,652	8,295	7,940

Source: BIS (2021b)

Total external debt and total external debt service have followed a similar pattern. Total external debt as percentage of GDP declined between 2000 and 2008 (37.9 and 27.5 percent respectively) and increased after 2010, reaching 47.9 and 56.2 percent of GDP in 2019 and 2020. Total external debt service as percentage of exports of goods and services also witnessed a decline in the first half of the 2000 (59.3 and 37.6 percent in 2004 and 2008) increasing to 50.9 and 59 percent in 2019 and 2020. The composition of external debt by sector, based on an analysis of international debt issues, shows that the general government is the largest bond issuer. On average, it accounted for 65 percent of the total stock of debt securities between 1990 and the first quarter of 2021. However, the share of the government's stock of debt securities has declined over time (88.4 in 1990 and 50.8 percent of the total in the first quarter of 2021).

In contrast, nonfinancial corporations, the second most important debt issuer in the region, have increased their debt stock of debt securities both in volume (US\$ 3.5 and 332.2 billion dollars between 1990 and 2021) and as a share of the total (5.7 and 36.3 percent of the total for the same years). Moreover, nonfinancial corporate debt has increased faster than any other sector since the Global Financial Crisis. The extensive use of the international bond market by the nonfinancial corporate sector was not a requirement to expand productive capacity. Since growth and investment have declined the increase in bond issuance is fundamentally associated with a strategy of financial accumulation.²³ Given that output has not expanded significantly, it is not a surprise that investment has not increased as firms have had little cause to expand their productive capacity faster.

The question is why would firms increase leverage even without the need to invest. One hypothesis focusses on the dynamics between firm cash flow and investment. It argues that both variables have a non-linear relationship. More precisely below a certain leverage (debt) threshold,

²³ This finding may indicate that, in line with recent research for other emerging market economies, the non-financial corporate sector does not use the international bond market to expand productive capacity or for improvements in productivity, but rather for financial purposes. See Bastos et al. (2016) and Advjiev (2014).

cash flow (derived from the issuance of bonds in the international capital markets) and investment (and obviously debt) have a positive association. Beyond that threshold the relationship turns negative as firms may feel more financially constrained, leading them to increase their retained earnings and cash holdings to protect themselves against illiquidity and ultimately insolvency.²⁴ Another hypothesis maintains that nonfinancial corporations become financial intermediaries by capturing international liquidity through bond issues and investing a growing amount in financial assets (Advjiev 2014; De Camino, Vera and Pérez Caldentey, 2021). The available evidence shows the region has been receiving increasing flows into financial assets from corporations outside the region. Those flows have been channeled through trade credit and cross-border loans and deposits and, especially, intercompany loans.²⁵

Existing accounting conventions classify intercompany loans as foreign direct investment (FDI), jointly with equity. FDI requires that the investor own at least 10 percent of the voting power of the direct investment firm. Any capital transaction of such an investor, including intercompany loans, is considered an FDI transaction, reflecting a long-lasting interest of the investor in the firm. However, in practice, intercompany loans are also driven by short-term concerns including financial speculation and therefore behave like portfolio flows. Available evidence for six Latin America countries (Argentina, Brazil, Chile, Colombia, Peru and Mexico) for the period 1990-2019 shows intercompany loans have increased since the 2000s. Furthermore, the increase has been particularly significant following the Global Financial Crisis (2008-2009). Between 2001-2009 and 2010-2019, intercompany loans increased by a factor of 25.7 for Colombia, 18.8 for Chile, 10.4 for Peru, 3.2 for Brazil, 1.5 for Argentina and 1.3 for Mexico. The significant rise in the value of intercompany loans has been accompanied by an increase in the share of total FDI flows. At the regional level, intercompany loans represented roughly 18 percent of FDI between 2005-2008, rising to 22 percent between 2010-2014 and to 24 percent of capital flows (De Camino, Vera and Pérez Caldentey, 2021).

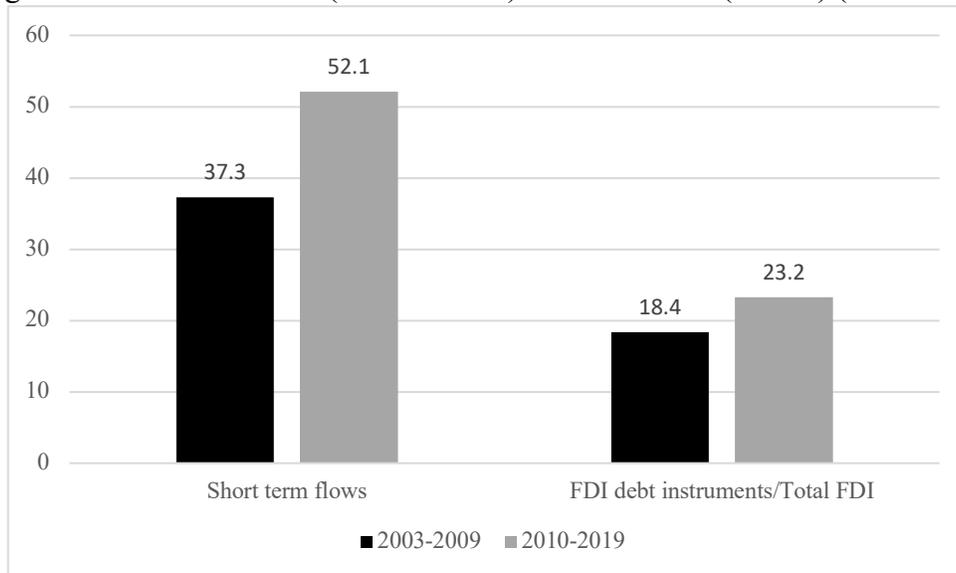
That development poses significant threats to financial stability and to economic and social development of Latin America and the Caribbean. The growing importance of the bond market as a primary source of cross border finance and the rise in absolute and relative terms in intercompany loans has exacerbated the dependency of Latin American countries on short-term flows. Available empirical evidence for inflows and their components for the periods 2003-2009 and 2010-2019 show that the share of short-term inflows in total inflows rose from 37.3% to 52.1%. Similarly, the

²⁴ An econometric estimation that relates investment in tangible assets to cash flow by degree of leverage for 270 firms in six Latin American countries (Argentina, Brazil, Chile, Colombia, Mexico and Peru) for the 2010–2016 period, shows that when leverage exceeds a 0.77 threshold, a 1% increase in cash flow-to-assets is associated with a reduction in investment of 0.25%–0.24%. In terms of the growth of tangible assets, the estimated equation shows that when leverage exceeds the 0.77 threshold a 1% increase in cash flow-to-assets is associated with a 0.75% reduction in the rate of growth of tangible assets. See Pérez Caldentey, Favreau-Negront and Méndez (2019).

²⁵ This explanation contrasts with the view that attributes to decline in investment to real factors, such as for example a lack of competitiveness due to an appreciated real exchange rate.

debt instrument component of FDI increased from 18.4% to 23.2% of total FDI for the same periods (Figure 6).

Figure 6: Short-term flows (% total flows) and debt flows (% FDI) (2003-2019)



Source: On the basis of IMF (2021)

Historically, financial flows have tended to co-move over the business cycle and behave pro-cyclically, especially in crisis episodes such as the Global Financial Crisis. In that episode, the rate of change in the stock of international debt securities declined from 22.2 to 5.1 percent between June 2007 and December 2008. In contrast, during COVID-19, international debt markets behaved counter-cyclically, expanding by 9 percent between March and December 2020. This also contrasts with the evolution of other flows such as FDI which contracted roughly by 50 percent in 2020. A major issue is how long and to what extent can the international bond market continue to be counter-cyclical in a context of lower growth, higher external debt, and unstable external conditions. To that must be added the announced tapering of financial expansion by the major central banks in advanced economies towards the end of the year (2021) which may increase the long-term yield on government securities, plus the possibility of a higher monetary policy interest rate over a longer-term horizon. Even if one takes these possibilities with some skepticism, the volatility caused by changes in interest rates could lead to significant crises in some of the countries in the region.

At the domestic level, countries have been able to issue sovereign debt in international bond markets in the recent past, and especially during the Pandemic, at historically low rates of interest owing to favorable external conditions. However, that does not imply the current debt levels of governments are sustainable. In fact, a simple empirical exercise for 2020 on the basis of projections of GDP and inflation shows that the real rate of interest on debt tends to be higher than the real rate of growth for some economies (including Colombia, the Dominican Republic, El Salvador, Guatemala, Trinidad and Tobago and Uruguay), which means countries will likely face

liquidity restrictions and situations of outright insolvency (IMF 2021).²⁶ Significant changes in interest rates, and volatility of the exchange rate, often accompanied by increasing perception of risk, might also affect the balance sheet of the nonfinancial corporate sector. The exchange-rate channel is particularly relevant for the nonfinancial corporate sector in emerging and developing economies, as their financial position is characterized by foreign-currency liabilities that are usually less-than-fully covered by foreign-currency assets and also by weak balance sheets (Borio, 2019, Vernengo and Pérez Caldentey, 2019).²⁷

Table 3: Firms with interest coverage rate equal to or less than one, 2020 (%)

Country	Share of firms with an interest coverage ratio equal or less than one	Share of firms' debt with an interest coverage ratio equal or less than one
Panama	53.8	39.6
Argentina	52.4	46.6
Brazil	46.3	41
Chile	39.8	16.9
Bolivia	35.3	34.6
Perú	29.3	23.3
Colombia	25.0	20.0
Uruguay	21.1	51.4
Latin America	27.9	37.0

Note: The sample includes 23,820 companies with a total debt of US\$ 1,9312 million; Source: Taliercio (2021)

The evidence available for selected Latin American countries for a sample of 23,820 companies shows the interest coverage ratio is equal to or less than one for more than a quarter of companies, and that 37 percent of the debt of those companies has an associated interest coverage index equal to or less than one (Table 3). The interest coverage ratio (i.e. earnings before interest and tax divided by interest) is an indicator of the facility with which a company can pay interest on its outstanding debt, and the extent to which a firm relies on short-term debt to pay its obligations. While there is no absolute threshold for the interest coverage ratio, values equal or below one may be an indication of a weaker financial position. This heightens the credit risk and financial fragility of the nonfinancial corporate sector.

Furthermore, the degree of the depreciation of the exchange rate is likely to be exacerbated if firms in a mismatch situation increase their demand for foreign currency to meet their foreign exchange liabilities. That could then fuel further capital outflows and also increase the debt burden. This is especially the case during the COVID-19 crisis as private capital markets have become an important source of finance for developing countries. Seventeen Latin American and Caribbean

²⁶ This exercise was based on the projections from 2021 to 2023 on growth and inflation by the IMF (IMF, 2021). The exercise assumed that nominal exchange rates remained constant throughout this period.

²⁷ Data for a range of countries in different developing regions suggest that currency mismatches have become more prevalent since the global financial crisis for emerging and developing economies. In most cases, the indicator of foreign currency mismatch has trended up, owing to the behaviour of the non-financial corporate sector (Chui, Kuruc and Turner, 2018).

countries have issued bonds between January and October 2020, worth US\$ 122 billion in total, which exceeds the amount issued for the entire year in 2019 (US\$ 118 billion).²⁸

Another source of potential financial instability would come from short-term portfolio flows, which are well-known for their dependence on volatile expectations and vulnerability to rapid changes in perception and subject to sudden reversions. This is not a remote possibility given the current circumstances created by COVID-19. Moreover, the dependence of short-term flows greatly reduces the policy space for counter cyclical fiscal and monetary policies.

They are the third most important source of foreign finance for the region. In the period 1990-2018, they represented roughly 20 percent of total flows to the region. Their contribution to sudden-stop capital episodes and balance of payments crises is fully recognized and has been traumatically experienced in the region in the past. Until the Global Financial Crisis, short-term capital flows took mainly the form of cross-border bank loans which was the most important form of international financial intermediation. In the aftermath of the crisis, the rate of growth of cross-border bank loans declined significantly. The available data shows that between 2001-2008 and 2010-2018, the rate of annual expansion of cross-border bank lending declined from an average of 14.6, 16.7, 16.0 percent to 7.5, -1.0, and 4.8 percent, for the United States, Eurozone and Japan, respectively. The slack in cross-border loans was taken up by the bond market. Available data for the period 2000-2018 for the United States, the Eurozone and Japan show that their combined lending to non-residents through their respective bond markets increased from US\$ 1.8 trillion in 2000 to US\$ 3 trillion at the end of 2008 reaching US\$ 6 trillion by December 2018. Since the beginning of Quantitative Easing (QE) policies by the Federal Reserve (FED) and the accumulation of banks reserves by the FED, the European Central Bank and the Bank of Japan, the share of international bond markets in total lending has risen steadily from 40 to 48 percent of global credit to non-residents.

Within a given economy, bond market indebtedness can have significant macroeconomic effects depending on the importance of the nonfinancial corporate sector, the state of its balance sheets, and external context. The evidence provided by Pérez-Caldentey et al. (2019) indicate that, on average, bond-issuing firms for the above countries represents 33.9 percent of total assets, 35 percent of expenditure on short-term investment, and 40.8 percent of expenditure on long-term investment.²⁹ The behavior of private capital markets during the Pandemic has strengthened the growing dependence of emerging market economies on short-term financing flows. All of this significant increase in financial fragility, has to be understood in a context in which the structural transformation of the pattern of accumulation in the region reinforces traditional paths of integration with the global economy, whereby countries are reliant on exports of commodities,

²⁸ Historically, low interest rates in developed economies (as a result of expansionary monetary policies) have encouraged investors to buy developing market debt in search of higher profits. The evidence available for the period 2017–2019 shows that profitability during 2020 (i.e. during the pandemic) increased. Profitability is proxied by the difference between the rate of interest charged on debt issues in the international capital market and the rate of interest of risk-free 10-year United States Treasury bonds.

²⁹ The data refers to the year 2016 and to averages of Argentina, Brazil, Chile, Colombia, Mexico and Peru.

produce manufactured goods with relatively high content of imported inputs, and depend on remittances. In such a context, premature financialization and financial fragility reinforce and worsen the problems created by premature deindustrialization.

5. Conclusion

This paper has explored the relation in Latin America and the Caribbean between what has been termed premature deindustrialization with what we refer analogously as premature financialization. Financialization, is associated with an increasing role of finance in the economy, one that is not justified by the needs of the real economy. It is also frequently connected with decline in the fortunes of the manufacturing sector and with deindustrialization. Discussion of financialization often presumes a certain degree of conflict between finance and industry, and the connotation in the literature is that financialization is associated with the rentier phase of the development of mature advanced economies. There are reasons to be skeptical that financialization must always come with decline of industrial capacity, as evidenced by the United States. So too financial and industrial interests are not always at odds,

Premature financialization is seen as symbiotically connected with the process of premature deindustrialization in Latin America. That process is associated with a development strategy that has emphasized a productive structure dependent on reprimarization and maquilization of exports. The danger in premature financialization is not so much the process of industrial decline, even if the two may be connected, but rather the possibility of increasing financial fragility. The evidence suggests that premature financialization has led to an increasing role for bond finance, plus increased financial fragility in the nonfinancial corporate sector. The significant expansion of private debt, through the bond issuance by the nonfinancial corporate sector, has gone hand in hand with a period of relatively lackluster growth.

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