Global Financial Cycle and Transmission Mechanisms in Emerging Markets

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Abstract:

The literature has identified the existence of a Global Financial Cycle that encompasses the occurrence of simultaneous movements in capital flows, risky asset prices, price of real goods (such as commodities, houses and land) and bank lending. It is argued that these impacts of the Global Financial Cycle in emerging economies can be understood as specific form of manifestations of financialization phenomenon. Due to the association of the processes of financialization and financial globalization in emerging markets, the Global Financial Cycle becomes a central element to understand the macroeconomic dynamics of these countries, especially those with deep external financial integration. Despite of the recent and rising literature about Global Financial Cycle and the impacts in domestic economy the transmission mechanisms are not entirely clean both in theoretical and empirical aspects in the emerging markets case. The hypothesis is that the Global Financial Cycle influences macroeconomic domestic cycles in emerging markets though the direct and indirect channels. In other words, the growth cycle in emerging markets is partly explained by the Global Financial Cycle. The contribution of this study is to on the analysis of transmission channels that explain this movement.

KEYWORDS: Financialization, Financial Globalization, Emerging Markets

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1. Introduction

The external scenario can influence the domestic macroeconomic through direct and indirect channels. However, the impact of international economy in a domestic one depends on the pattern of external insertion and how the effects of external scenario reverberate on macroeconomic dynamics.

In this context, the external insertion becomes a vital factor for understand the effects of international economy has in the macroeconomic performance of a specific domestic economy. In general terms, in the peripheral economies the external insertion is subordinated in monetary, financial, technological and productive aspects. The constraints imposed by this specific pattern of external insertion are fundamental to understand the macroeconomic dynamics in short and long run-term.

In financial aspects, the literature has identified a phenomenon called Global Financial Cycle that encompasses the occurrence of simultaneous movements in capital flows, risky asset prices, price of real goods (such as commodities, houses and land) and bank lending. The main determinants of this Global Financial Cycle are the interest rate of the funding currencies and the investors risk aversion in international financial markets (REY, 2018).

It is argued that these impacts of the Global Financial Cycle in emerging economies can be understood as specific form of manifestations of financialization

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phenomenon. Due to the association of the processes of financialization and financial globalization in emerging markets, the Global Financial Cycle becomes a central element to understand the macroeconomic dynamics of these countries, especially those with deep external financial integration. Despite of the recent and rising literature about Global Financial Cycle and the impacts in domestic economy the transmission mechanisms are not entirely clean both in theoretical and empirical aspects in the emerging markets case.

The hypothesis is that the Global Financial Cycle influences macroeconomic domestic cycles in emerging markets though the direct and indirect channels. In other words, the growth cycle in emerging markets is partly explained by the Global Financial Cycle. The contribution of this study is to on the analysis of transmission channels that explain this movement.

In the first part will be discussed the financialization and financial globalization in emerging markets. In the second part will be described the direct and indirect channels. The direct channels are associated with the asset pricing, such as exchange rate, stock market and real assets prices (commodities, land and houses). In case of indirect effects there are many possibilities of transmission mechanisms. Will be describing the possibility of procyclical monetary and fiscal policies and the influence of capital flows and asset prices on credit supply by domestic banks. It is essential understand the impacts of asset prices and capital flows in macroeconomic dynamics in emerging markets in terms of cyclical growth.

2. Methodological Approach

The methodological approach is based on heterodox principles, mainly the post-keynesian macroeconomic view and the Latin America structuralism school. This methodological approach was originally proposed by Fritz, Prates & De Paula (2016) and denominated as “Keynesian-struturalist analysis”. As the name suggests, this particular methodological approach congregates elements of the post-Keynesian and the structuralism view.

From the post-Keynesian view, the starting point is the understanding of the capitalist economic as a Monetary Economy of Production. There are six principles that define a Monetary Economy of Production: principle of production (firms search for monetary profits), principle of dominant strategy (asymmetry between the economic agents), principle of temporality (production requires time), principle of non-ergodicity (irreversibility of time), principle of coordination (no central planning mechanism) and principle of the properties of money (zero elasticity of production and substitution) (CARVALHO, 1992; OREIRO, 2011).

The principles of a Monetary Economy of Production denote the centrality of money in a post-Keynesian view. As Keynes (1933) pointed out, in monetary economies the money is capable to influence motives and decisions, not acting as a mere instrument of exchange. Amado (2000) emphasizes that the communion of three elements of the post-Keynesian monetary theory: the conception of time, the uncertainty and the principles of money, allows concluding non-neutrality of money in a short and long-term.

The process of financialization reinforces the importance of money and point out to the centrality of finance in the macroeconomic dynamics. The financialization process impacts the behaviour of banks, other financial corporations, non-financial corporations, families and governments (though macroeconomic policies). Soon, in the context of Monetary Economies of Production under financialization, the
finances, in a general meaning, can influence real variables such as income and employment. Kregs (2017) rescues the concept of Monetary Economy of Production to put in doubt the dichotomy between real and monetary sides or between finance and production in capitalist economies. The influence of finance sphere in the real variables is one manifestation of financialization process. So, it is imperative incorporate monetary and financial aspects to analyse the macroeconomic dynamics.

However, once the focus of this research is to analyse the emerging markets, it is important to considerer the subordinate external insertion in the monetary financial spheres. As consequence of the incapability of the domestic currencies of perform the classical functions in the international level, the emerging markets presents a higher external vulnerabilities and lower degree of macroeconomic policy autonomy (PRATES, 2005). This particular external insertion in the International Monetary and Financial System can shapes the behaviour of economic agents influence in macroeconomic dynamics. According to Kaltenbrunner & Painceira (2017), even the financialization process develops in a particular way in emerging markets.

The theoretical framework proposed, denominated Financial Macroeconomics at the Periphery, arises with the purpose of providing instruments for analysing macroeconomic dynamic in “financialized” emerging markets – peripheral countries engaged in the process of financial globalization and financialization associated with international capital flows. In those countries the macroeconomic dynamics can be affected by changes in international finance.

3. Financial Macroeconomic at the Periphery

Finances, in general, influence both the evolution of the capitalist as mode of production as well as the macroeconomic dynamics in a short and long-short. Great economic thinkers such as Marx, Hilferding, Schumpeter, Keynes and Minsky highlighted the importance of finances in these two dimensions. From the theoretical point of view, this influence has been discussed through a series of concepts and different theoretical approaches. In common, these approaches put the finances in spotlight, a vital component to understand contemporary capitalism.

Following the theoretical framework proposed, this section presents two main concepts of Financial Macroeconomics at the Periphery: financialization and financial globalization. The aim is to analyse this process in light of post-Keynesian and structuralism perspective.

3.1. Financialization

The concept of financialization has been described in different areas of social and human science as a series of economic phenomenon and a specific configuration of capitalism. The definition of financialization, its manifestations forms and its effects depends on the theoretical approach. On one hand, this widespread use of the term financialization is an unmistakable sign of its relevance. In the other hand, the absence of a clear definition can difficult the understanding of the phenomenon.

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2 According to Prates & Andrade (2012) the emerging markets are the peripheral countries engaged in the financial globalization.

Lapavitsas (2011) analysis how the process of financialization is approached by three heterodox thinking: Marxist, Post-Keynesian and others such as French Regulation School. The financialization process is defined as “a systematic transformation of mature capitalist economies” (Lapavitsas, 2011, p.1) and has three main features. Firstly, as large non-financial corporations acquire skills to act directly in financial markets. Because of that, these corporations are less depending of traditional bank credit for obtains financing. As consequence, commercial banks reorient their operations and sources of profitability, acting mainly as intermediary of resources. Finally, the families are also affected by the financialization process, which increasingly assume liabilities and acquire financial assets.

According to Van Der Zwan (2013) the financialization process is an element of contemporary capitalism, an expression of dominance of finance ante industrial sphere. Despite common elements, there are differences approaches. For the purposes analysis, the author presents the concept of financialization in three approaches. For the Regulation School, the financialization is a specific accumulation regime characterized by centrality of finance. In a domestic economy this phenomenon is manifested in an increasing importance of finance for non-financial corporations. On the asset side, the profits of these corporations depend more on financial revenues. On the liabilities side, the interest payment is increasing due to the raising of leverage. The impacts include the reduction of long-term growth and the weakening of the productive sphere. From an external point of view, the financialization is related to the capital flows liberalization, the cyclical nature of growth (boom & bust cycle) and external vulnerability.

The second manifestation of financialization process is based on the shareholder value and its effects on non-corporate financial institutions decisions of financing and spending. Finally, it presents the concept of financialization of everyday life, highlighting how families become “financialized” via acquisition of financial assets and assumption of liabilities (VAN DER ZWAN, 2013).

3.1.1. Financialization: Post-Keynesian Approach

Despite there is no consensus about the financialization process, Epstein (2005) present the most referenced definition, “financialization means the growing role of financial motives, financial markets, financial agents and financial institutions in the operation of the domestic and international economies ”(p.3). So, the financialization process is related with the increasing relevance, relative and absolute, of the finance.

Stockhammer (2004) also presents a definition for the concept of financialization. According to the author, "financing is a recent, poorly defined term that summarizes a wide range of phenomena, including the globalization of financial markets, shareholder value revolution and the rise in income from financial investment "(p.720) or "financialization is a recent term to capture transformations in the financial sector and other economic sectors "(p.720). In these general terms, the financialization process is defined as financial transformations in domestic and international level. As consequence, the finances become more influent in macroeconomic dynamics. More narrowly, financialization process is defined as "an increase in the activity of non-financial businesses in the financial markets" (p.720).

The recent studies of Jan Kregel, exponent of post-Keynesian thinking, and Robert Guttmann, important author associated with the Regulation School, add new elements to understanding the concept of financialization. For Kregel (2017),
the financialization emerge with the deregulation of the US financial system and the introduction of new financial instruments that allowed the indebtedness increasing. As the author points out, "from this point of view financialization could be defined as the result of financing becoming self-referential or a preference for holding financial assets resulting in the dominance of speculation over enterprise "(Kregel, 2017,p.885). So, financialization process is related of predominance of finances over production. Therefore, to understand the concept of financialization would be necessary to question the dichotomy between the real/production side and the monetary/financial side. As the production process requires finance, the finances become one determinant of economic growth. The financialization process impacts the real side through the interaction channels between the two spheres.

Guttmann (2017) presents two different concepts of financialization process. The first, financial centralization, defined as "as "structural changes making non-financial actors more dependent on debt-financing as well as financial-income sources "(p.857) or" the process whereby non-financial actors, both firms as well as households, "financialize" inasmuch as they end up accumulating much larger stocks of financial assets and liabilities. "(p.860). Finances influence the consumption of families and revenues of non-financial corporations, whether by financial assets or by the degree of indebtedness. In turn, financial concentration is defined as an “increased weight to the financial sector in the economy (p. 840), reflecting the financial sector, banking and non-banking, to gain relative in GDP.

According to Guttmann (2017), the process of financialization is based on changes in domestic and international financial markets, but also in its interaction with other economic sectors. Non-banking financial institutions, such as institutional investors and the shadow banking system, become more relevant for financial market dynamics. For example, the emergence of institutional investors and governance corporate focused on the shareholder value has changed the dynamics of financial markets and their relationship with non-financial corporations. In this growth regime, denominated as finance-led capitalism, the finance influences economic growth and income distribution. There are two main channels: the expansion of consumption through wealth effect (asset inflation) and credit banking expanding.

For Ramos (2017), the financialization process presents three main forms of manifestation. The first includes the changes in the relationship between finance and the other sectors, the emergence of shareholder value and the rise of the rentier. The second aspect of financialization is related with the product and process innovations in financial markets. In this aspect, there is a change in the commercial banks behavior, acting as intermediary in financial markets (market-based banking system); the introduction of innovations, such as derivatives; the financialization of commodity and currency markets.

According to Treeck (2012), "In the context of a closed private economy, we can define financialization as, broadly speaking, a combination of: a primary orientation by firms towards shareholder value; increasing income and wealth inequalities between shareholders and higher management on the one hand, and ordinary
employees on the other; and easier access to credit for private households, including low-income groups." (p. 2)

For Treeck (2012), "the Post Keynesian concept of financialization is a structuralist alternative to the largely ahistorical, neoliberal notions of ‘financial deregulation’ or ‘financial liberalization’" (p.1), so, for the post-Keynesian point of view the financialization is a structural element associated with a particular historical context. The main question of this analysis is the impact of financialization in income distribution and, consequently, in economic growth. From the Regulation School perspective, financialization is a regime of regulation that replaces the Fordist regime, “the ‘finance-led’ or ‘finance-dominated’ growth regime can be understood as the successor model to the ‘Golden Age of Capitalism’ or the ‘Fordist growth model’ of the postwar decades” (p.1).

Lapavitsas (2011) argues that the post-Keynesian view of financialization is based on the growth of financial sector and the importance the finance over production. Understanding that there is a rivalry between the two spheres: once the expansion of the financial sector is responsible for the poor performance of the economy in the “real side”. Financialization is direct associated with the rentier’s supremacy. According to the author "the rentier - a parasitical economic entity - extracts profits due to the scarcity of capital, and therefore, depression and profitability. For Keynes, successful capitalism requires the 'euthanasia of the rentier' effected through low interest rates" (Lapavitsas, 2011, p.615).

Conforming to Palley (2013) there are three main channels through financialization can influence economic dynamics. The first one is the impact of financialization on real economic side by financialized consumption as a result of wealth effect. In the other hand, the devaluation of this financial wealth can result in a decrease of the consumption. The increase of families indebtedness contribute to raising the share of income committed with interest payments. In your turn, a higher interest payment means more banking profitability and capitalist consumption. For non-financial corporations, the financialization process appears on the rise of indebtedness and the shareholder value orientation. Finally, financialization results in more political and economic power for those agents aligned with financial market interest. The impact of financialization on growth seems dubious, although the author affirms that the long-term growth trend is reduced about of financialized.

In summary, it is possible to list the main forms of manifestation of the phenomenon of financialization. Considering the transformations of the financial system, the financialization means the increasing of financial sector in the economic; the predominance of financial markets over a banking credit based economy; income transfers from real sector to the financial one; growth of financial institutions and markets; increased financial instruments. For non-financial corporations the financialization means the rise of shareholder value orientation, the increasing of financial fragility and indebtedness, increasing the relevance of financial gains to non-financial agents; growth of the stock of financial assets and liabilities. In a macroeconomic level financialization results in the growing importance of finance in economic, political and social terms; tendency towards stagnation of productive investments, resulting in the decrease of long-term economic rate of growth; the increasing importance of financial gain; changes in the functional distribution of income in favor of profits and to the detriment of wages.

An important topic is the impact the finance in private agents expanding. Aglietta's concept of "Financial Macroeconomics" is especially useful. For Aglietta (2000) financial liberalization conditions the agent’s behavior. One of the main channels is the impact of financial liberalization on the pricing of financial assets and the repercussion on expenses. Coutinho & Belluzzo (1998) affirm that with the advent of "financialization" families, banks and non-financialisation companies are left with more financial assets. The wealth effect can influence the level of investment and consumption. In consumption case, the domestic credit banking is the main transmission mechanism. The financial asset inflation allows a higher degree of household indebtedness. A similar mechanism operates for non-financial corporations. The valuation of financial assets improves risk assessment and increase of the market value of publicly traded companies would allow the expansion of indebtedness. On the other hand, the deflation of financial wealth would impair the agent’s ability to honor their debts, wide spreading the financial fragility to banking system.

As Whalen (2017) highlighted, most of the recent developments about the concept of financialization were already present in Minsky’s studies. One example is the concept of money manager capitalism for characterized the post-1980 period in the United States as liberalization progressed and financial deregulation in the wake of neoliberalism and changes in changes in institutional innovations. The main characteristics would be the emergence of institutional investor as major holders of private equity and debt securities, the reduction of the banking system as a provider of finance and the intensification of financial innovations, such as securitization and derivatives, which allowed the credit expansion and indebtedness. The logic of these funds, concentrators of financial wealth at the global level, would be the valuation of capital for the shareholder (MINSKY, 1996; MINSKY & WHALEN, 1996; WRAY, 2009; WHALEN, 2017). O money manager capitalism is described as “the presente period, in constrat, is one of money-manager capitalism, where financial markets and arrangements are dominated by institutional investors” (Minsky & Whalen, 1996, p. 156).

The capitalism finance-oriented impacts on the large corporations. The manager’s remuneration is strongly dependent by short-term financial results. So, the companies would be oriented for capital gains in short-term in detriment of productive investment with long maturation time. There is an increase in the firm’s financial fragility. The firms are exposed to growing indebtedness and price variation of financial assets, which increases the perception of uncertainty. In macroeconomic terms, the financial fragility of firms and the degree of importance that the essentially volatile financial markets assume increases the risk of systemic financial crises. In addition, the combination of short-term investment orientation associated with the reduction of internal resources available for investment, would result in the reduction of investments of greater maturity, which could result in the stagnation of technological progress in the long term (MINSKY, 1996; MINSKY & WHALEN, 1996; WRAY, 2009; WHALEN, 2017).

From the post-Keynesian firm theory it is possible to discuss how financialization affects the behavior of non-financial corporations and introduces a measure to solve the agency problem between owners/shareholders and managers. The conflict lies on the discrepancy of interests, usually manifested in the dispute over cash flows. While the stockholders are interested in short-term gains, such as
stock appreciation and higher return on capital invested, managers want to accumulate power and expand the corporation. Following this logic, there is a tendency in the first group for the greater distribution of dividends, while the second would tend to channel resources for investments the growth of the company. The logic of value maximization for the shareholder seeks to resolve this agency conflict through the supremacy of the financial markets. Managers are co-opted with compensation practices and start to act in favor of shareholder’s interests. Large corporations now act by means of logic of the short-term profitability, focusing on the valuation of stocks and the return on equity. This posture tends to reduce the growth rate of firms, through reduction of productive investments, as well as the financial fragility increases due to the increase in the degree of indebtedness (STOCKHAMMER, 2004; HEIN & TREECK, 2010; TREECK, 2012; PALLEY, 2013).

According to Treeck (2012), in macroeconomic terms, the results would be inconclusive because of the ambiguity of some impacts. As far as growth is concerned, the shareholder value strategy tends to aggregate investments, that is, the accumulation of capital. However, financialization also presents elements capable of increasing consumption, despite the redistribution of income in favor of profits, maintaining the rate of profit and capital accumulation. The redistribution of income in favor of profits and the payment of dividends contribute positively to the consumption of the capital holders (including the holders of shares). On the consumption of the workers the results would be ambiguous, since on the one hand there is the loss of participation of the wages in the income, associated to the tendency of deregulation of the labor market. The greater access to credit by households can, on the other hand, increase the consumption financed, but on the other hand, the degree of indebtedness and commitment of the income with the payment of interest.

As for the tendency towards financial fragility, Minsky (1986, 1992) highlights the Financial Fragility Hypothesis. According to which economic units can be classified according to the degree of financial fragility, expressed by the relation between the financial cost of the liabilities assumed and the expected profitability of the assets. Units with lower financial fragility would be described as hedge. In these expected incomes would be sufficient to bear interest and the principal of the debt in all periods. In the case of speculative units there would be a mismatch of short-term maturities, with income covering only the payment of interest, but which in the long run would be equated. Finally, the most fragile units would be called Ponzi, in which case the expected income would be insufficient to pay interest. An economy in which there is predominance of hegde units would be, from the macroeconomic point of view, more stable, in the sense of prone to financial crises, than an economy with a strong presence of speculative units and Ponzi. However, in periods of stability economic units would tend to shift from hedge positions to speculative and Ponzi positions.

3.1.2. Financialization: International Dimension in Emerging Markets

The definitions of Epstein (2005) and Stockhammer (2004), quoted in the previous section, already emphasize the international dimension of the financialization and their directly association with the financial globalization. According to Palley (2013), “there is a strong international dimension to financialization that centers on the elimination of capital controls, encouraging all
countries to deregulate their internal financial markets” (p.36). So, there is a relationship between the two financial movements: the financialization and the financial globalization.

For Ramos (2017), it is necessary to differentiate these two phenomena but also understand the elements that interconnect them. The increasing magnitude and importance of international financial markets is also a phenomena associated with the financialization process. According to the author’s definition “financialization at the international level can be defined as the increasing magnitude of finance in the international sphere, where the prior function of financing trade and production are substituted by the strengthened speculative motive” (Ramos, 2017, p. 983). So, one of the manifestation’s forms of financialization is directly related to the deeper financial external integration, promoted by the liberalization and deregulation process in international financial markets.

However, beyond the discussion about financialization in international dimension is mandatory analyzing the specificities of emerging markets. According to Bonizzi (2013), financialization is therefore not a linear process and assumes different forms in developing countries vis-à-vis advanced economies as well as country-specific forms” (p. 85). According to Kaltenbrunner & Painceira (2017) there are similarities between the financialization process in emerging and develop countries. However, there are some peculiarities too, mainly because of subordinate external insertion in the International Monetary and Financial System, expressed by the international hierarchy of currencies. These countries present a pattern of asymmetric financialization that would derive from the traditional process of financialization, but which would assume specific characteristics in the case of emerging countries due to subordinate external insertion in financial globalization. Thus, as previously discussed, the financialization can affect the agent’s behavior. In the emerging markets case, the financialization process develops together with the constraints imposed by financial globalization and subordinate external insertion.

As consequence of the lower liquidity of their domestic’s currencies, the emerging markets present greater structural external vulnerability and lesser degree of autonomy of macroeconomics policy. In the context of macroeconomic policies, there would be specificities regarding the dynamics and level of the interest rate and the exchange rate. Emerging countries would need to maintain higher interest rates than those in central countries in order to attract capital inflows. As for the exchange rate, these countries would present greater volatility and latent pressures for devaluation, due to the volatility of capital flows and the permanent risks of sudden stops with reversal of the international liquidity scenarios. Capital flows, driven essentially by external factors, would be essentially volatile. The stock of external commitments of these countries, with high mobility, could be reallocated due to changes in the external scenario (KALTENBRUNNER & PAINCEIRA, 2017; DE CONTI, PRATES & PLIHON, 2014).

Finally, Kaltenbrunner & Painceira (2017) highlighted two forms of manifestation of asymmetric financialization. The first one is the foreign exchange reserve accumulation process by central banks and the effects on commercial banks. In periods of net capital inflows, central banks carry out sterilization operations in order to contain excess exchange rate appreciation. The sterilization operations involve the issuance of short-term repos, with high liquidity and high profitability. The repos are bought for commercial banks. In response to the possession of short-term assets the commercial banks issued short-term liabilities, mainly certificates of deposit. As a consequence of the accumulation of reserves there is an expansion of
the balance sheets of banks with a predominance of liabilities and short-term assets. The second manifestation is the impact of structural external vulnerability on non-financial corporations. The main mechanism would be the need for these corporations to hedge against exchange rate variations through the acquisition of derivatives. However, companies would also operate in these markets for the purpose of speculation.

3.2. International Finance and the Emerging Markets

International finance is another central element of the Financial Macroeconomics in the Periphery. Two key concepts are discussed in this subsection: globalization financial system - a specific institutional arrangement of the International Monetary and Financial System - and the Global Financial Cycle - a concept related to the stylized fact about the cyclical behavior of global financial variables.

3.2.1. Financial Globalization in Emerging Markets

The financial globalization has been described as institutional transformation and changes in the modus operandis of domestic and international financial markets. The French economist François Chesnais defines the financial globalization from the processes of liberalization and deregulation of the domestic financial markets and the emergence of a global financial market from the integration between them (CHESNAIS, 1996; 1998).

So, in qualitative terms, beyond the liberalization and the deregulation, the financial globalization is characterized by the predominance of market finance over bank finance, the widespread use of financial innovations such as derivatives and the securitization, and the emergence of large institutional investors such as insurance companies and pension funds. The pattern of capital flows has also change. On the qualitative side, the predominance of private capital flows, mainly direct and portfolio investment. From a quantitative point of view, there is an increase in capital flows and external assets and liabilities (CARNEIRO, 1999; BIANCARELLI, 2011).

The International Monetary and Financial System have a new configuration in the globalization era. The US dollar, the main international currency, became fiduciary, financial and flexible. The first two characteristics refer, respectively, to the absence of formal convertibility of gold and the centrality of US financial system and the role of dollar as an international financial asset. Flexible refers to the predominance of flexible exchange rate regimes. In addition, there is a high level of international capital flows mobility. Finally, the International Monetary and Financial System are hierarchical (CARNEIRO, 1999; PRATES, 2005; BIANCARELLI, 2008).

The main asymmetry, known as monetary asymmetry, is related to the position of domestic currency in the international currency hierarchy. The currencies issued by emerging markets are unable to act as currencies in the international level, i.e., cannot fulfil the three classical functions of currency at this level. So, monetary asymmetry refers to the concept of currency hierarchy which states that national currencies have different capacities to perform the classical functions of currency internationally. The US dollar is the only one capable of fulfilling this function in its fullness at the international level. The lower position of the domestic currency in
this hierarchy results on greater external vulnerability in the monetary-financial sphere and less macroeconomic policy space (COHEN, 1998; COHEN 2004; CARNEIRO, 1999; PRATES, 2005; DE CONTI, PRATES & PLIHON, 2014; DE PAULA, FRITZ & PRATES, 2017).

According to Prates (2005), from the monetary asymmetry emerges the financial asymmetry. As originally proposed, the financial asymmetry has two main dimensions. The first concerns to the minor share of emerging markets in the international investors’ portfolio and the permanent risk of sudden stops. The second is related to the importance of external factors as determinant of capital flows to emerging markets. As consequence, the emerging markets are more externally vulnerable. As consequence of financial asymmetry the emerging markets has less macroeconomic police space. In macroeconomic terms, the interest rates tend to be higher in emerging markets than in develop ones due to the illiquidity of their currencies. The exchange rates also have peculiarities in emerging markets, mainly resulting in higher volatility and abrupt devaluations.

3.2.2. Global Financial Cycle

In terms of theoretical innovation and recent empirical evidence on international finance, the Helene Rey contribution’s is heightened. Rey (2015) identifies, through empirical analysis, the existence of Global Financial cycle defined as a simultaneous occurrence of cycles of gross capital flows, risk asset prices and credit/leverage. As the author pointed out “‘risky asset prices around the globe, from stocks to corporate bonds, have a strong common component. So do capital flows. Credit flows are particularly procyclical and volatile” (REY, 2018, p. 2).

The determinants of the Global Financial Cycle are the level of the interest rate associated with the funding currencies and the degree of risk aversion in international financial markets (REY, 2013, REY, 2015). A domestic macroeconomics elements of each individual country is irrelevant. According ro Rey “the global financial cycle can be related to monetary conditions in the centre country and to changes in risk aversion and uncertainty” (REY, 2018, p. 2) e “the global financial cycle is not aligned with countries’ specific macroeconomic conditions”(REY, 2018, p. 17).

The boom phase of Global Financial Cycle starts with the decrease of US interest rates that leads to a fall of risk aversion, an increase of bank leverage, intensifying of gross capital flows, asset price inflation, domestic credit expansion and pro-fiscal policies. The US interest rates is the main driver of the Global Financial Cycle and the global banks are the principle transmission mechanism. Changes in global banks leverage can influence credit conditions, boosting capital flows and promoting asset inflation (MIRANDA-AGRIPPINO & REY, 2012).

In the bust phase the abrupt cessation of external funding reaches even the economies as solid macroeconomic foundations. This movement exacerbates the external vulnerability and increase the likelihood of crises through currency devaluation. The agents with liabilities denominated in foreign currency could face problems of liquidity and solvency (CALVO, 1998; CALVO & REINHART, 2000; REY, 2015; POWELL & TAVELLA, 2015; REINHART & REINHART, 2008; DE CONTI, BIANCARELLI & ROSSI, 2013; BLUEDORN et al, 2013).

The phenomenon of the Global Financial Cycle, as described by Rey (2015), has two dimensions: capital flows and asset inflation. In analytical terms, and in view of
the proposed objectives, it is distinguish between the elements that make up the Global Financial Cycle and how to manifestation in emerging countries.

The first dimension of the Global Financial Cycle refers to capital flows. As described in the previous session, the advance of financial globalization has intensified structural elements of international finance, such as intrinsic instability, speculative dynamics, SMFI asymmetries, and the cyclical nature of capital flows to emerging economies. The cyclical availability of financing external to emerging economies has several denominations in the literature (surges, bonanzas, waves, episodes, boom & bust cycles in capital flows, famine & feast or international liquidity cycles), but very similar approaches to the phenomenon. There is periods for the expansion of the supply of external financing, in the form of capital flows in various categories, for emerging economies. The main determinants of this international liquidity supply would be the level of the interest rates of the countries issuing currencies and the degree of risk aversion / appetite in the international financial markets (DE CONTI, BIANCARELLI & ROSSI, 2013).

The boom phases, i.e., periods of high international liquidity, starts with a fall in interest rates associated with funding currencies. On the one hand, the decrease of the yield on securities denominated in those currencies and issued by central countries would encourage investors to reallocate part of their portfolio to more profitable assets. However, international liquidity cycles go beyond simple portfolio relocation, but also involve the creation of financial wealth. The lower interest rates encourage investors to take funding in central currencies to acquire assets with higher return. The share of portfolio investors allocated in emerging markets depends on the degree of risk aversion in international financial markets. However, periods high liquidity for emerging economies are essentially ephemeral, even if can be prolonged for years, and tend to be abruptly interrupted (DE CONTI, BIANCARELLI & ROSSI, 2013).

The reversal tends to be driven by an increase in the interest rate of the currencies and by the abrupt increase in risk aversion. Therefore, in the bust phase, the investors tend to settle their positions in emerging markets for pay the debts denominated in funding currencies. This movement leads to a reconfiguration of the portfolio of international investors, with an increase in the number of insurance assets issued by countries denominated in hard currencies, and reducing the denominated in peripheral currencies and issued by emerging countries (DE CONTI, BIANCARELLI & ROSSI, 2013).

Concerning the asset inflation the central point is how the main drivers of Global Financial Cycle impacts asset prices around the world. It should be noted, a priori, that the dynamics of asset inflation (or deflation) may be linked to capital flows. Despite the fact that capital flows are an important to influence the pricing of these assets over the cycle, it is possible to other instruments. It is necessary to distinguish the phenomenon by assets categories. The first of these refers to financialization of commodities market BONIZZI, 2013; CHICOSKI, 2016; CARRERA, 2018). So, changes in commodity prices can be understood as a global manifestation of the external financial cycle, since these assets become instruments of speculation.

There are three classes of assets when considering the specific assets of emerging markets: monetary, financial and real. The first is the currency itself, which’s the pricing dynamics are analyzed through the nominal exchange rate trajectory. Again, there is a discussion on the financialisation of currencies and the exchange rate, the impact of the overall liquidity conditions on nominal exchange rates. In this case, there may or may not be a direct relationship for the country
under review, given the importance that derivatives - which do not directly involve capital flows - exercised in the pricing of assets (ROSSI, 2016; KALTENBRUNNER & PAINCEIRA, 2017; RAMOS, 2017). Concerning the financial assets, the importance is evaluating the dynamics of stock prices and corporate and public debt securities denominated in domestic or foreign currency. It can also include the dynamics of country risk measures such as EMBI (Emerging Markets Bonds Index) and CDS (Credit Default Swap). In the case of real assets, already excluding commodities, the pricing of real estate and land is emphasized.

4. Transmission Mechanisms in Emerging Markets

The advancement of financialization and financial globalization in emerging economies has intensified the transmission mechanisms between financially open emerging economies. Through channels The Global Financial Cycle impacts the macroeconomic dynamics of emerging markets. The Global Financial Cycle can affect the agents spending decisions and, as consequence, the economic growth. This influence of Global Financial Cycle in macroeconomic dynamics in emerging markets is understood as a particular manifestation of financialization and financial globalization process in those countries. The influence in economic growth is intermediate though asset inflation/deflation, availability of external funding, impacts on domestic banking credit and macroeconomic policy. These changes can influence the level of consumption, investment, exports and governmental spending.

Regarding the availability of external financing, the Global Financial Cycle manifestations is the relative importance of external factors as capital flows drivers. The vast literature of drivers of capital flows to emerging markets has already highlighted the importance of external factors. According to Resende & Amado (2007) the economic cycle of emerging economies Latin American countries (Argentina, Brazil and Mexico) has a reflexive to the international liquidity cycle. One of the transmission mechanisms would be external constraint due to the excess of external financing. However, if in the boom phase the excess of external financing relaxes the macroeconomic level, the bust phase related to financial fragility in the previous phase. The fluctuations in external financing, and their possible consequences in terms of external financial fragility, are one of the mechanisms of between the Global Financial Cycle and the dynamics of emerging economies. A second manifestation is the influence of the Global Financial Cycle on asset pricing, such as domestic currency, financial assets (stocks and bonds financial and real assets (with emphasis on commodities and real estate) (ROSSI, 2016, CHICOSKI, 2016, KALTENBRUNNER & PAINCEIRA, 2017; RAMOS, 2017).

The domestic banking credit is also another manifestation of Global Financial Cycle in emerging markets. The first channel is related to the external funding from banks. The domestic banks assume liabilities in external markets as source of funding for domestic lending. Another channel is the wealth effect from inflation/deflation of financial assets and their impact on credit expansion (CALVO, 1998; CALVO & REINHART, 2000; REY, 2015; POWELL & TAVELLA, 2015; REINHART & REINHART, 2008; CUNHA et al, 2016; BIANCARELLI, ROSA & VERGHANINI, 2017).

The Global Financial Cycle may affect emerging markets though pro-cyclical macroeconomic policies in relation to the external financial cycle. The transmission channels are multiple in this case, but the main idea is that there is a stimulus for the adoption of macroeconomic pro-cyclical policy in boom phase of Global Financial
Cycle (KAMINSKY, REINHART & VEGH, 2004). In the case of monetary policy, there are two channels between to the Global Financial Cycle and the nominal and real short-term interest rates. The first one is related to the dynamics of domestic inflation. In a context of high availability of external financing the nominal exchange rate appreciation contribute to the reduction of inflation through a lowering of imported inputs. Obviously, the intensity of this mechanism depends on the degree of openness for imports, the dynamics of the nominal exchange rate, that is, the sensitivity to changes in the external scenario, and the pass-through rate exchange rates and domestic prices. Since there is a reduction in inflation it is possible that there will be changes in the real and nominal interest rates, depending on the performance of the Central Bank. The second mechanism, the nominal interest rates can be reduced because of the decreased of country risk measures (OCAMPO, 2010) or/and the reduction of interest rates in central economies. With the excess to external financing the emerging markets can reduce their domestic interest rates and continue to receive capital inflows. As the large amounts of international liquidity are related to low interest rates in countries and countries that are considered country risk (CDS and Embi) also fluctuate in a cyclical way, there is room for the reduction of the nominal domestic interest rate.

From the fiscal point of view, the Global Financial Cycle can influence the economic through a series of channels. On the revenue side, appreciation of commodity prices and increased exports can increase government revenue and allow increased spending without raising fiscal deficits. The fiscal side is also affected by the dynamics of state financing, either by external indebtedness *stricto sensu* or by the participation of foreigners in public debt. In addition, public debt management is influenced by the need for sterilization operations and by reserve accumulation policies.

5. Final Remarks

The objective of the chapter is to present the transmission mechanisms between the Global Financial Cycle and the macroeconomic dynamics in emerging markets "financialized". From a theoretical point of view, the analysis is based on the post-Keynesian-structuralist, bringing together elements of post-Keynesian macroeconomics with the structuralist view of center and periphery. It is argued that it is necessary to make mediations between the abstract theoretical contributions and the analysis of “real” economies.

As a particular manifestation of the financialization process, which affects the peripheral economies inserted in the financial globalization, the Global Financial Cycle is able to influence the decisions of private agent spending and the conduct of the economic policy. The mediation between international finances and the domestic economic cycle occurs through the impact of the Global Financial Cycle on the pricing of domestic assets, the availability of external financing and the impact on domestic credit and the possibility of adopting pro-cyclical economic policies.

6. References


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